

Government and Consumer Intervenors¹, “GCI”, and the City of Chicago, in addition to submitting the following Brief on Exceptions, have prepared as Exceptions an entirely revised proposed order to replace the Hearing Examiners Proposed Order (“HEPO”). The HEPO fails to fairly and completely present the evidence presented, the positions of the GCI/City parties, the issues before the Commission, or an adequate analysis of the issues. The HEPO therefore deprives the Commission of the opportunity to accurately and fairly decide this very important and far-reaching case. Accordingly, as replacement language, as required by 83 Ill. Adm. Code 200.830, GCI/City’s Exceptions are a completely revised order which (1) discusses the evidence presented; (2) fairly presents the positions of all parties; (3) provides the Commission with the appropriate analytic framework; and (4) includes a comprehensive analysis of the issues such as whether the Plan has met statutory and regulatory goals and requirements; and (5) addresses all issues presented by the parties, including depreciation, the revenue analyses, and rate design issues.

SUMMARY OF POSITION

When the Commission announced its intention, more than six years ago, to initiate an alternative form of regulation for Illinois Bell Telephone Company (“IBT” or “Ameritech Illinois” or “AI”), the first reason it cited for its decision was the need to address what it believed was the increasingly difficult task of balancing the needs of ratepayers, IBT and its shareholders. Alt. Reg. Order at 19. This balancing standard is a well-established tenet of utility ratemaking. “Properly designed alternative regulation,” the Commission observed, would allow the Commission to “implement safeguards” and “allocate risk” in a manner that protected the interests of all parties. Id. Ultimately, the Commission fashioned precautions and safeguards to protect ratepayers and to maintain this balance during the much-anticipated transition to competition.

Contrary to expectations, however, competition for residential customers has not really materialized in the past six years. The precautions and safeguards designed when the Commission saw competition “just around the corner” are therefore ill-suited for the present economic environment. The carefully crafted “balance” has tilted, in our opinion, increasingly in favor of AI’s interests and that of its shareholders. The result is that the plan, created before the Commission could possibly know the unique ways in which the telecommunications landscape would

¹ GCI is composed of the People of the State of Illinois, ex rel James E. Ryan, Attorney General (“AG”), Cook County State’s Attorney’s Office (“SSAO”), and the Citizens Utility Board (“CUB”).

develop, is no longer producing just and reasonable rates. It is no longer, in the words of the General Assembly, “a more appropriate form of regulation.”

Our proposals are offered with the intention of righting the regulatory balance . First, we seek a finding, based on the plan’s six-year history, that the current alternative regulation plan is no longer functioning in a manner that can protect ratepayers given the current state of competition. Second, in order to create a more appropriate form of regulation, we propose that the Commission re-initialize rates to once again restore the balance between ratepayers, the Company and its shareholders. Third, this new plan must include the statutorily-mandated three year rate cap, as required by Section 13-506.1(c) of the Act. For reasons set forth by the General Assembly, which we explain below, the Commission should also order an expansion of the cap to cover Band B telephone calls and should direct that the rate cap remain in place for the life of the plan. Fourth, the Commission should also reinitialize the Company’s productivity benchmark to capture AI’s new operational strengths as part of SBC Communications, Inc. Finally, we urge the Commission to safeguard the financial compensation credits designed to protect customers who are the victims of AI’s service failures by rejecting the HEPO’s recommendation that such compensation be used to offset any other service quality penalties which the Commission may elect in its discretion to impose.

I. INTRODUCTION

The Proposed Order correctly observes that the purpose of this docket is a comprehensive review of the performance of the alternative regulation plan. It states: “The issue at this stage is whether the Plan, as established in 1994, has performed in accordance with both statutory goals outlined in the Act and the regulatory goals and expectations set out in the Alt Reg Order,” HEPO at 5(Section I). Yet, the HEPO’s actual evaluation of the Plan is cursory. It reflects a presumption that the Plan is an end in itself while presenting contradictory reasoning and misstatements of parties’ positions. These errors permeate the HEPO and result in a superficial analysis, and unfair and unlawful conclusions.

GCI/City propose a different analytical framework, based on the Public Utilities Act, section 13-506.1 and sound regulatory policy. First, the Order in this docket should recognize the fundamental principle that the alternative regulation plan for Ameritech Illinois (AI) was adopted, upon AI’s petition, as an experiment. In the first alternative regulation order, ICC Docket 92-0448/93-0239 (“Alt Reg Order”), the Commission observed that “...any

alternative form of regulation must be carefully monitored to ensure that its intended effects are being realized.”

Alt. Reg. Order at 20. The Commission pointedly left open future consideration of earnings, stating that “the initial alternative regulatory plan” does not preclude future review of revenues or revenue sharing. Alt. Reg. Order at 51. At other points the Commission emphasized that the Order was its “first implementation of price regulation” and that it would use results from other jurisdictions “as a frame of reference for the analysis of results in Illinois, and for the identification of any emerging or potential problem areas.” *Id.* at 35. See also *id.* at 92.

A second guiding legal principle, absent from the HEPO, is that alternative regulation is a ratemaking tool and this is a ratemaking proceeding. The General Assembly granted the Commission authority to approve alternative forms of regulation not as an end in itself but as a means to set just and reasonable rates:

“Notwithstanding any of the ratemaking provisions of this Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services...”

220 ILCS 5/13-506.1(a) (emphasis added). The General Assembly did not change the definition of just and reasonable rates, and did not abandon the just and reasonable standard. No matter how technical the subject under consideration in this proceeding, the goal of just and reasonable rates is paramount.

In addressing the question of “just and reasonable rates” and ignoring GCI/City’s argument that a 43% profit level is too high, the HEPO presents what can only be described as contradictory reasoning. On the one hand, the Examiners reject GCI/City’s argument that AI’s 43% profit level under the Plan is evidence that the plan has not worked as the Commission originally intended and that current rates under the Plan are not fair, just and reasonable. The Examiners snub GCI/City’s reference to AI’s 43% profit level as evidence of the need to reinitialize rates, and assert that the determination as to whether AI’s rates meet the fair, just and reasonable standard “cannot be made by an assessment of earnings calculated “under a wholly different regulatory scheme.” HEPO at 35. Indeed, the Examiners chastise the GCI/City parties in the “Rate Reinitialization” portion of the HEPO, opining that “GCI/City cannot seem to break away from the idea that earnings, such an integral part of ROR regulation, do not hold the same prominence under alternative regulation.” HEPO at 110 (Sec. VI).

Yet, in the same breath, the Examiners endorse Staff’s “zone of reasonableness” test, which examines

earnings (and thereby deems earnings relevant) and assumes that rates are just and reasonable if earnings fall within a “zone” bounded on the lower end by considerations of the Company’s financial integrity and on the higher end by earnings levels that “clearly exceed those that could be explained by enhanced cost effectiveness and technical and market progressiveness of the regulated company.” HEPO at 30 (Section III.1). Clearly the Commission needs to know what AI’s earnings are to determine whether they fall within the “zone of reasonableness” yet the HEPO does not include this information. This analytical seesaw is flawed from both a policy and a legal perspective.

In assessing whether AI’s rates are just and reasonable, AI’s earnings under the Plan must be assessed. That requires an analysis of the Company’s financial performance, which is ordinarily done to determine a company’s rate of return. Simply reviewing whether the mechanics of the Plan have been implemented, as recommended by AI and sometimes by Staff, does not answer the basic questions presented by this docket: Has the Plan resulted in just and reasonable rates and does the Plan represent a more appropriate form of regulation than rate of return regulation?

A third issue is whether the Plan fairly and appropriately anticipated the changes in the telecommunications market. The Plan was based on the Commission’s assessment of expected changes in telecommunications technology, and that “...competition is likely to increase in the future and the regulatory policies of this State should be directed toward a successful transition to a more competitive environment.” Alt Reg Order at 19; see also *id.* at 3. Although various parties presented evidence and arguments on the role of technology and the state of competition, and their effects on the operation of the Plan, the HEPO failed to address the level of competition for Ameritech customers, whether this competition has been sufficient to protect consumers and therefore function as a substitute for regulation, the effect of competition on the success of the Plan, and the success of the Plan in generating competition.

GCI/City will address those sections of the HEPO to which they have exceptions. The proposed language is contained in a separate document entitled Exceptions, which is a wholly rewritten order.

II. THE 10 POINT REVIEW - Commission Specific Issues

The HEPO presents the issues correctly, but fails to make the historical evaluation of the Plan needed to decide whether the Plan represents a more appropriate form of regulation than other regulatory schemes, or how a future plan might be designed to meet that legal standard. GCI/City propose that the Order specifically evaluate

each question presented in the 1994 Alt. Reg. Order.

- (a) **Does the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation?**

GCI/City do not oppose the description of the issue in this section of the HEPO. However, in Commission Analysis and Conclusion, the only the question presented is whether the GDPPI provides an adequate reflection of economy-wide inflation. The evidence showed that the fixed weighted GDPPI was not an adequate measure because it was restated periodically, resulting in double counting and a distortion of the inflation factor. Therefore, it has not been an adequate measure, and should be changed.

- (b) **An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.**

GCI/City object to the HEPO's presentation of this issue. The HEPO fails to assess whether the Plan's productivity adjustment, or X-factor, reflected the Company's productivity gains under the Plan, and whether it should be modified. The HEPO presents AI and Staff evidence about the X-factor going-forward, but fails to "assess" whether the existing X-factor has been adequate or should be modified.

GCI/City modify the HEPO to discuss the evidence on whether the X-factor has been adequate and should be modified, while leaving evidence on the X-factor going-forward to a later section. GCI/City conclude that the X-factor has captured only a small portion of AI's productivity savings during the course of the Plan, and that a modification of the X-factor and/or the Plan are necessary to insure a fair balance between ratepayer benefits and Company profits.

- (c) **Whether the adopted monitoring and reporting requirements should be retained or adjusted.**

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Although the HEPO presents the positions of the parties relative to monitoring and reporting requirements, it declines to reach a conclusion on whether these requirements have been adequate, should be retained, or adjusted. In the Exceptions submitted with this Brief, language assessing the need for monitoring and reporting requirements is included in this section of the Order.

- (d) **The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.**

The issue of network modernization was the subject of extensive testimony and discussion in this docket. However, the HEPO fails to address the key issue of whether AI's investments have led to network modernization. Instead, the HEPO trivializes this question into whether AI showed that it spent the \$3 billion it pledged to invest in 1994. In the Exceptions submitted with this Brief, the issues relative to network modernization are presented, and the conclusion that AI's investment in infrastructure has been inadequate to avoid severe service quality problems is reached.

- (e) **A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.**

Again, the HEPO limits the discussion of this issue to whether a list of services has been submitted by AI. It fails to provide any analysis of the significance of the information contained in the list. Surely the Commission required AI to submit a listing of all services in each basket and the associated price changes so it could assess the price changes occurring under the Plan and determine how various classes of customers fared under the Plan. The HEPO side-steps this analysis, saying that "there are issues raised here which will be discussed further in this Order." HEPO at 16. Unfortunately, the HEPO is silent on what those issues are, or where they are discussed.

The Exceptions submitted with this Brief set out the issues raised by AI's listing of services and price changes, and concludes that under the Plan there has been an imbalance in the benefits received by small and moderate residential consumers compared to high volume residential consumers.

- (f) **A listing of any services which have been withdrawn during the period.**

This section has not been changed.

- (g) **A listing of all services which have been reclassified as competitive or noncompetitive during the period.**

The HEPO concludes that AI has complied with the requirement to provide a listing of reclassified services "in letter if not in spirit" and defers assessment of reclassifications occurring during the life the Plan. The Exceptions submitted with this Brief provide the Commission with an clearer understanding of the issues presented by AI's extensive reclassifications, and concludes that reclassifications have had extensive, unanticipated negative effects on the Plan. Further, it concludes that the Commission must address the incentives to and effect of reclassifications in any Plan going-forward.

- (h) **A summary of new services which have been introduced during the period.**

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The HEPO again evades the issues raised by the summary of new services submitted by AI by concluding

that AI “provided the list required.” HEPO at 20. The 1994 Order required AI to provide the

summary of new services so it could assess the new services arising under the Plan. The

Exceptions submitted with this Brief describe the responses of Staff and the GCI/City parties to

the summary of new services provided by AI, and addresses the issue raised by AI witness

Gebhardt’s concession that its new services are really price and packaging changes. These parties

also raise the effect of treating residential calling plans as “new services” on the effectiveness of

the pricing constraints of the Plan. The Exceptions conclude that AI has used the new services

provision of the Plan to undermine the residential basket price protections.

- (i) **Information regarding any changes in universal service levels in Illinois Bell’s service territory during the price cap period.**

The attached Exceptions add a discussion of the City’s arguments relative to universal service, and its response to AI’s contention that its rates are “generally low”. The City pointed out that AI’s rates for access and usage are higher than 2/3 of the cities included in a 95 American city survey, and that over 185,000 customers were disconnected for lack of payment in 1999.

Although GCI/City do not change the ultimate conclusion of the HEPO in regard to this issue, the Commission Conclusions in the Exceptions attached to this Brief point out that AI was ordered to provide universal service information for its service territory and that it failed to do so. This failure to comply with the Alt Reg Order’s specific requirement hampers the Commission’s ability to address this issue.

III. THE STATUTORY CRITERIA AND GOALS

1. Has the Plan Produced Fair, Just, and Reasonable Rates

Authority: Sections 13-103; 13-506.1(a); 13-506.1(b) and the Alt Reg Order.

Whether the Plan has produced “fair, just and reasonable rates” is the most crucial question raised in this docket. Yet, the HEPO’s presentation of this issue is garbled, confused, internally inconsistent and wholly lacking in legal authority or sound analysis. GCI/City have substantially revised this section (1) to objectively and fairly present each party’s position, and the criticisms of each party’s position; (2) to provide legal authority for the

analysis adopted; and (3) to apply legal principles to record evidence.

Section 13-506.1 makes it plain that the purpose of alternative regulation, like the purpose of regulation in general, is to maintain fair, just and reasonable rates. The issues before the Commission are: how should it determine whether AI's rates are fair, just and reasonable, and what adjustments should be made if it concludes that current rates do not meet this statutory standard?

A. A Review of AI's Earnings Is Mandated by Illinois Law and Requires the Commission to Balance Shareholder and Ratepayer Interests.

When the Commission adopted alternative regulation for AI, it repeatedly stated that the Plan was an experiment and that review was necessary to insure that the terms of the Plan were properly set. *Id.* at 20, 35, 51. The rates set in that case were based on a 1991-92 test year, data that is now ten years old, and the Order was entered 7 years ago. In this review proceeding, the Commission must assess whether the Plan captured the cost savings it anticipated in 1994, and whether the rates based on a 1991-92 test year have been appropriately adjusted under the Plan to remain just and reasonable.

GCI/City maintain that the cost savings and increased revenues realized by AI over the past 7 years have outstripped the price cap adjustments to the extent that the balance between ratepayer and shareholder interests has tipped deeply in favor of shareholders. The returns described below, regardless of whether they were calculated by AI, Staff or GCI/City, dramatically exceed a market required return. A rate adjustment, outside the price cap, is necessary to bring them back to just and reasonable levels.

The extent of the rate adjustment must be based on the record evidence of the reasonable cost of capital for AI. Once accounting adjustments are made upon review of GCI/City, Staff and AI proposals, AI's rates should be reduced to reflect a fair balance between shareholders and ratepayers and set at just and reasonable levels.

The HEPO rejects AI's position that earnings are wholly irrelevant to the assessment of whether rates are fair, just and reasonable and concludes that AI's earnings should be assessed under the "zone of reasonableness" test proposed by Staff for the first time in its Reply Brief. HEPO at 36 (section III.1). Without discussing the evidence or AI's earnings further, the HEPO represents that "Staff" concluded that AI's earnings are reasonable and therefore the Commission should blindly adopt that position. The HEPO neglects to inform the Commission that Staff also concluded that AI's rates are \$837.576 million more than necessary to cover the reasonable cost of capital

and provide a return of 40.1%. App. A to Staff Initial Brief; Staff Ex. 30, 30.01 (Voss).

In determining whether the Plan has produced just and reasonable rates, the Commission is obligated to balance the interests of shareholders and the consuming public. Shareholders are entitled to a reasonable return on their investment, and the consuming public is entitled to rates that reflect the reasonable value of the services, and are based on the actual cost of providing service. Citizens Utility Board v. Illinois Commerce Commission, *supra*, 276 Ill.App.3d at 737; 220 ILCS 5/1-102(a)(iii)&(iv) (220 ILCS 5/13-101). Alternative regulation is a vehicle to achieve just and reasonable rates through “alternative” regulatory means. It was not intended to be a vehicle to justify staggeringly high profits as the Commission recognized when it stated that “unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective.” Alt Reg. Order at 92. The balancing of shareholder and public interests must be made in reviewing or setting rates under alternative regulation.

GCI/City agree that considering AI’s earnings in the context of a zone of reasonableness is an appropriate method to insure that rates remain fair, just and reasonable under alternative regulation. 220 ILCS 5/13-506.1. However, the HEPO discussion of this standard lacks the necessary analysis of the evidence or of the legal standard applicable to this case.

Specifically, the HEPO fails to provide the Commission with the extensive data on AI’s earnings that are included in the record. AI, Staff, and GCI/City all made detailed presentations of AI’s revenues, rate base, depreciation expense, and other expenses. AI Ex. 7.0, 7.1, 7.2 (Dominak); Staff Ex. 4, 18, 29 (Marshall); 5, 19, 30 (Voss); 6, 20, 31 (Hathhorn); 7, 21, 32 (Everson); GCI/City Ex. 6, 6.2 (Smith); 8.0, 9.0 (Dunkel). Staff and AI presented witnesses who described investors’ expected return on their investment, based on an analysis of capital markets. AI Ex. 6 (Ibbotson); Staff Ex. 11, 25 (Pregozen). The Order in this docket should describe the evidence and address the issues raised by these analyses, and use them to determine the zone of reasonableness. The attached Exceptions provide that analysis in section III.1.

The HEPO also fails to discuss the legal basis for the zone of reasonableness test. Illinois courts have addressed what constitutes “just and reasonable” rates on many occasions. In Citizens Utility Board v. ICC, 276 Ill. App.3d 730, 736-737, 658 N.E.2d 1194, 1200 (1st Dist. 1995), the Court referred to extensive precedent for the

proposition that fixing just and reasonable rates “involves a balancing of the investor and the consumer interests.”

Quoting Illinois Bell Telephone Co. v. Illinois Commerce Commission, 414 Ill. 275, 287, 111 N.E.2d 329 (1953), quoting Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603, 88 L.Ed. 333, 345, 64 S.Ct. 281, 288 (1944). The Court continued:

The Commission has the responsibility of balancing the right of the utility’s investors to a fair rate of return against the right of the public that it pay no more than the reasonable value of the utility’s services. While the rates allowed can never be so low as to be confiscatory, within this outer boundary, if the rightful expectations of the investors are not compatible with those of the consuming public, it is the latter which must prevail.

Quoting Camelot Utilities Inc. v. Illinois Commerce Commission, 51 Ill. App.3d 5, 10, 365 N.E.2d 312 (1977).

The principle that investors are entitled to a fair return on their investment and that the consuming public is entitled to rates that are no more than the reasonable value of the utility’s services defines just and reasonable rates and sets the zone of reasonableness. Further, Illinois Courts have made clear that when the interests of investors conflict with the interests of consumers, consumers’ interests and expectations “must prevail.” This Commission has also recognized these principles. For example, in a recent Order the Commission stated: “An overriding principle in the Commission’s determination of whether a tariff is just and reasonable involves a balancing by the Commission of the interests of the utilities’ stockholders and customers.” ICC Docket 00-0390, Order at 4 (March 14, 2001).

AI argued that earnings are irrelevant, relying instead on the fact that rates decreased under the price index and on comparisons to the Consumer Price Index. However, section 13-506.1 does not redefine “just and reasonable rates.” It does not replace the term “fair, just and reasonable rates” or otherwise change that term’s specific legal definition. Even though the cases addressing just and reasonable rates have ordinarily been decided in the rate of return context, in assessing whether rates comply with the United States Constitution, the United States Supreme Court has stated that the specific decisions which lead a Commission to a final rate is not as important as whether the rate itself provides the company with a fair return. Duquesne Light Co. v. Barasch, 488 U.S. 299, 109 S.Ct. 609, 102 L.Ed. 2d 646 (1989). By analogy, alternative regulation is a way to achieve just and reasonable rates – it does

not redefine just and reasonable rates or abandon the premise that shareholder and ratepayer interests must be balanced when public utility rates are set.

B. The Record Demonstrates That AI's Rates Are Not Fair, Just and Reasonable, That it Has Received Unreasonably High Profits, and That the Balance Between Shareholders and Ratepayers Has Been Lost.

The evidence of AI's earnings included accounting analyses as well as cost of capital analyses. Both AI and Staff presented testimony on the return investors expect, based on the market cost of capital. AI's witness, Dr. Roger Ibbotson, testified that shareholders expect an overall, weighted return on rate base of between 10.58% - 11.21%, and a return on common equity of between 11.86% - 12.71%. Dr. Ibbotson's analysis reflected a common equity ratio of 75.09%. AI Ex. 6.

Alan Pregozen testified for Staff. He concluded that shareholders expect an overall, weighted return on rate base of 10.52% and a return on common equity of between 11.80% - 14.40%, with a midpoint of 13.10%. His analysis reflected a common equity ratio of 59.94%. Staff Ex. 11. These recommendations constitute record evidence of investors' expectations and required return on capital, and form one part of the "zone of reasonableness" analysis. The Commission can compare AI's actual returns against the market based return to determine whether ratepayer and shareholder interests are being fairly balanced under alternative regulation.

AI witness Timothy Dominak presented AI's analysis of its operations. He calculated the Company's results of operations during the Plan, 1995 through 1999, and the Company's response to AG Data Request 1.1, which was part of GCI Ex. 1.2, showed the Company's reported return on equity for Ameritech Illinois as follows:

	AI's Calculation of Return on Rate Base	AI's Calculation of AI's Return on Common Equity
1995	9.43%	20.56%
1996	10.53%	18.89%
1997	14.25%	22.93%
1998	13.92%	23.97%
1999	19.15%	29.29%

For 2000, the following information was filed as part of AI's annual report² (Exhibits B and D):

² GCI/City request the Commission to take administrative notice of Ameritech Illinois' annual report filed on March 30, 2001 pursuant to the Alt Reg Order. 83 Ill. Adm. Code 200.640(a)(3).

2000	23.80%	28.60%
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After various accounting changes were made in response to Staff and GCI/City testimony, Mr. Dominak maintained that AI's 1999 return on rate base was 18.82%. AI Ex. 7.3 at 5. The details of the accounting issues, including the calculation of depreciation, are discussed below.

AI presented 1999 as its test year, and GCI/City witnesses conducted a close analysis of AI's 1999 results of operations. While the specifics of their analyses will be discussed below, Mr. Ralph Smith, a Certified Public Accountant and utility regulatory specialist, concluded the AI's earnings for 1999 were as follows:

	GCI/City's Calculation of AI's Return on Rate Base	GCI/City's Calculation of AI's Return on Common Equity
1999	28.49%	43.08%

GCI Ex. 6.2 at 3 revised. Several Staff witnesses also reviewed AI's results of operation for 1999. Staff demonstrated that AI received a 26.7% return on intrastate rate base in 1999, an amount significantly higher³ than the 10.52% weighted return on rate base Staff found to be a reasonable return. Staff Ex. 30, Sch. 30.01; Staff Ex. 13. Its statement of operating income results in a 40.1% return on equity, which is quite close to the GCI/City calculation of 43%.

In determining whether AI's rates are just and reasonable, or are within the "zone of reasonableness," the Commission should focus on investors' expectations as testified to by Dr. Ibbotson and Mr. Pregozen, and on the cost of providing service to consumers, as summarized by Staff witness Bill Voss and GCI/City witness Ralph Smith. This evidence will provide the Commission with the information it needs to determine whether AI's rates represent a fair balance between shareholder and ratepayer interests, are just and reasonable under alternative regulation, and whether rate adjustments should be made. Inexplicably, the HEPO did not mention any of this record evidence.

GCI/City maintain that the evidence is clear that AI's earnings are far above a reasonable upper limit. The return on rate base calculated by the Company (18.82% on surrebuttal), is 778 basis points above the high end of Dr. Ibbotson's recommended cost of capital. Staff calculated that AI is receiving a 26.7% return on rate base, which is

³Staff's analysis showed that AI's rates were \$837,576,000 higher than it needed to provide a reasonable return on rate base. Staff Ex. 30.01, App. A to Staff's Initial Brief.

1,618 basis points, or two and a half times higher than the overall cost of capital calculated by Staff (10.52%). GCI/City's calculated return on rate base of 28.49% is similar to Staff's, being 1,797 basis points above the overall return on rate base calculated by Staff. GCI/City showed that AI's return on rate base is 1728 to 1791 basis points higher than AI witness Dr. Ibbotson's recommended range. GCI/City maintain that returns of this magnitude demonstrate that alternative regulation has unfairly benefited shareholders to the detriment of ratepayers.

C. The Recognition That Alternative Regulation May Result in Earnings above the Authorized Return Does Not Justify the Abandonment of A Fair Balance Between Shareholders and Ratepayers in this Review Proceeding.

AI argues that one tenet of alternative regulation is the expectation that it can earn more than its authorized return. It is clear that over the course of the Plan the Company did earn more than its authorized rate of return – significantly more. However, the Plan was never intended to authorize sustained, unlimited profits. As the HEPO points out, the Commission expected the price index and market forces to limit high, monopoly earnings. Alt Reg Order at 187; HEPO at section III.1. The question on this review is: have the price index and market forces succeeded in limiting monopoly profits? GCI/City maintain that they have not.

In further response to AI's [and Staff's] argument that the Plan recognized the possibility of higher earnings, GCI/City point out that they have not challenged AI's right to keep the extraordinarily high returns reported during the Plan. However, upon review, it is plain that the magnitude of these returns demonstrates that the resulting rates are no longer fair to consumers. The sustained high earnings during the Plan demonstrate that the balance between consumers and shareholders has tipped decisively in favor of shareholders, and this docket is an opportunity to restore the balance to a just and reasonable level.

D. AI's Earnings must Be Reviewed for Both Competitive and Noncompetitive Services to Determine If Overall Rates Are Just and Reasonable.

The Examiners conclude that the analysis of fair, just and reasonable rates under the Plan applies only to rates for noncompetitive services. HEPO at Section II, subsection 1, par. 3 (Conclusion section). The Commission should reject this notion. First, the statutory requirement that rates be fair, just and reasonable is not limited to noncompetitive services. See, e.g., 220 ILCS 5/13-506.1(b)(2), 13-103(a), 13-505. As intervenor witnesses TerKeurst and Selwyn pointed out, a regulatory plan that encourages reclassification of services as competitive with

corresponding price *increases* does not further the goals of fostering competition, protecting consumers or providing just and reasonable rates. See GCI Ex. 11.0 at 25-26; City Ex. 1.0 at 43-44. A review of the Plan must include a review of these effects.

Second, all of AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources. As noted by Dr. Selwyn, the FCC has concluded that it is not possible to develop jurisdiction-specific estimates of total factor productivity because it concluded that no economically meaningful separation of state and interstate inputs could be made. City of Chicago Ex. 1.0 at 44. This same reasoning applies to services labeled as competitive and noncompetitive. Because the Commission no longer requires detailed cost studies to support "competitive" services, it has no adequate means of determining whether AI is over allocating costs to noncompetitive services, thereby depressing the noncompetitive rate of return, while under allocating costs to competitive services. Id. Further, Staff witness Judith Marshall testified that in December, 1999, AI representatives told Staff that AI was unable to provide a breakdown of earnings between competitive and noncompetitive services because there was no generally accepted methodology to allocate embedded costs between competitive and noncompetitive services. Ms. Marshall found AI's newfound study produced less than a year later to be arbitrary, and concluded that there was no relationship between the revenues used by AI in its "study" and the embedded cost of service. She also pointed out that there is no relationship between long run service incremental costs (LRSIC) and the embedded cost of providing service. She concluded that "there is no reliable method of calculating AI's earned returns on non-competitive services." Staff Ex. 4.0 at 6.

As pointed out earlier in this Brief, the Commission has reviewed several of AI's competitive reclassifications and found them premature, ordering refunds and reclassification back to noncompetitive status. A docketed proceeding currently is underway to examine the propriety of AI's reclassification of several residential and business noncompetitive services to competitive. Docket No. 98-0860; see also City of Chicago Ex. 1.2. As noted by GCI witness TerKeurst, AI has repeatedly taken the position in that docket that the term "reasonably available from more than one provider"⁴ merely requires, for example, a showing that competitors have the potential

⁴ Section 13-502(b) of the Act states: "A service shall be classified as competitive only if, and only to the extent that, for some identifiable class or group of customers in an exchange, group of exchanges, or some other clearly defined geographical area, such service, or its functional equivalent, or a substitute service, is reasonably available from more than one provider, whether or not any such provider is a telecommunications carrier subject to regulation under this Act."

ability to serve customers at some point in the future. When the Commission first approved price cap regulation for AI in 1994, only 7% of the Company's revenues were derived from competitive services. Today, AI reports that about 58% of the Company's intrastate revenues come from competitive services. GCI Ex. 1.0 at 27. As noted above, this massive reclassification effort has been accompanied by rate increases for some of these services. See City of Chicago Ex. 1.2. As noted by Dr. Selwyn, "(t)he very fact that such rate increases were possible as an economic matter for services that were already priced in excess of their costs and that ostensibly faced actual competition undermines fundamentally the Company's contention that any such competition is present in the first place." City of Chicago Ex. 1.0 at 45-46.

In short, it is absurd to assert that the review of a plan designed to bring about an efficient transition to a competitive marketplace should ignore the effects the plan has on the classification of services as competitive and whether the rates paid by AI's customers are in conflict with the just and reasonable standard. Such a limited review, in effect, furthers the incentive already in the plan to prematurely reclassify services as competitive and then abuse the Company's market power through subsequent or contemporaneous rate increases. See GCI Ex. 11.0 at 26. Accordingly, the Examiners' recommendation to ignore the earnings produced by its competitive services when examining the Company's returns should be flatly rejected.

GCI/City's proposed language is included in the Exceptions filed with this Brief at section III.1.

2. The Plan Has Marginally Reduced Regulatory Delay and Costs Over Time.

The HEPO concludes that the Plan has reduced regulatory delay and costs over time. GCI/City agree that the Plan contained simplified three month proceedings, but point out that there have been other protracted proceedings, brought about at least in part by the Plan's incentives to reclassify services as competitive, even if price constraining competition is absent. The GCI/City Exceptions conclude that the Plan satisfied the policy consideration in section 13-506.1(a)(1), but that significant regulatory delay and costs remain.

3. The Plan Has Not Encouraged Innovation in Telecommunications Services.

The HEPO concludes that "[w]hile innovations which Ameritech describes are limited, there is not relevant on the record to suggest that the Plan failed to encourage innovation." HEPO at 39 (Section III.3) However, the

record reveals that Privacy Manager is the only “innovation” cited by AI that was not previously offered to consumers. All other innovations represent price changes, which are not what was intended by the consideration in section 13-506.1(a)(2) that alternative regulation “encourage innovation in services.” 220 ILCS 5/13-506.1(a)(2). Further, AI admitted that service innovations stem from equipment vendors rather than from AI. GCI/City’s Exceptions conclude that there have been limited innovations during the Plan and that the Plan has not encouraged innovation.

4. The Plan Anticipated Changes That Did Not Occur, Leaving Consumers of Services Classified as Competitive Paying Excessive Rates.

The HEPO concludes that “without question” AI has had to respond to and adapt to changes in wireless and internet technologies. HEPO at 41 (Section III.4). GCI/City maintain that this does not address the question of whether the Plan “responds to changes in technology and the structure of the telecommunications industry that are, in fact, occurring” as required by section 13-506.1(b)(3). The question is not whether wireless or internet technologies have developed during the Plan, but whether the Plan responded to actual changes.

The record demonstrates that the Commission expected that competition would arise to supplant regulation, and that competitive services would be subject to price constraining competition while noncompetitive services would be subject to the price cap. The HEPO fails to address evidence showing that these expectations have not been fulfilled.

The HEPO does not address the fact that as of September, 2000, only 3.56% of the lines in AI’s service territory were resold, and only 2.7% were provided on a UNE loop basis, while 59 competitors participate in this small market segment. Although AI predicted vigorous competition in 1994, and now argues that marketplace dynamics are even more compelling, the evidence demonstrates that in fact there has been insignificant competition for AI’s services.

Consistent with statements in other Commission Orders (See ICC Docket 00-0670, Order at 16), GCI/City’s Exceptions conclude that the lack of competition is a major Commission concern. The lack of competition has undermined a central premise of the Plan, i.e. that competition would constrain prices of services not subject to the price index. The changes in the marketplace anticipated by the Plan have not in fact occurred, and the high earnings realized by AI during the course of the Plan demonstrate the failure of competition to constrain

prices as the Commission intended.

5. Consumers Have Not Received a Reasonable Portion of Efficiency Gains and Cost Savings Achieved During the Plan.

GCI/City restate their arguments and AI's response to more clearly convey their belief that AI's high earnings demonstrate that the Plan did not flow a reasonable portion of efficiency gains and cost savings to consumers. Section 13-506.1(b)(5) requires a Plan to "specifically identif[y] how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change." Although the Plan included a 1% consumer productivity dividend (CPD), AI's earnings grew to more than double their pre-Plan levels. Despite yearly price reductions under the price index, the X factor, which included the CPD, did not capture a significant part of the cost savings and efficiencies available to the Company. GCI/City conclude that a rate reduction is necessary to more closely match prices with efficiencies and to give consumers the benefit of a reasonable portion of the efficiencies and cost savings occurring under the Plan.

6. The Plan Has Disadvantaged Users of "Plain Old Telephone Service" Relative to Other Consumers.

The HEPO concludes that no class was prejudiced or disadvantaged under the Plan because the basket structure was intended to insure that the various customer classes each received benefits under the Plan. The HEPO further concludes that no party compared different rate classes, so no finding of prejudice could be made. HEPO at 46 (Section III.6).

Section 13-507.1(b)(7) requires that the Plan "will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers." There has been no reduction in the residential network access line charge, despite close to 7 years of declining costs for the Company. AI targeted high use residential customers by increasing the volume discount instead of decreasing prices for network access or Band A usage.

This asymmetry has resulted in some consumers benefitting from the Plan more than others despite the service baskets and pricing limitations.

GCI/City conclude that the service baskets have not operated as expected to avoid Ramsey pricing, and that

some changes to the baskets is necessary going forward.

7. Broad Dissemination of Technical Improvements and Economic Development.

Section 13-506.1(a)(4) and (5) provide that the Commission shall consider whether the plan will facilitate the broad dissemination of technical improvements to all classes of ratepayers and enhance economic development of the State. The HEPO concludes that this factor was “fulfilled”. HEPO at 49 (section III.7). It suggests that because the Company spent \$3.7 billion over the five years of the Plan, and only committed to spending \$3 billion, it delivered on its promised network modernization. The HEPO ignores the undisputed fact that service quality for POTS customers as well as for wholesale customers has deteriorated markedly during the Plan, and that SBC’s own chairman admitted that these problems were the result of insufficient network investment.

The attached Exceptions conclude that AI has not shown that it has broadly disseminated technical improvements and enhanced economic development during the Plan. The service quality problems, combined with SBC chairman Whitacre’s admission of lack of network investment, show that sufficient investment has not been made during the course of the Plan.

8. Competition

The HEPO only partially represents GCI/City’s position about the development of competition, and then castigates GCI/City for not taking a broader view. Specifically, the HEPO represents that GCI/City argued that the Plan was intended to promote competition, but concludes that that is not the role of the Plan. The HEPO creates a strawman and then predictably blows it down.

In actuality, GCI/City argued that despite the Commission’s intention that competition replace regulation, competition has not developed to the point where it can constrain prices. Section 13-103(b) provides:
consistent with the protection of consumers of telecommunications services and the furtherance of other public interest goals, competition in all telecommunications service markets should be pursued as a substitute for regulation in determining the variety, quality and price of telecommunications services and that the economic burdens of regulation should be reduced to the extent possible consistent with the furtherance of market competition and protection of the public interest.”

Therefore, the question before the Commission is whether competition has developed to the extent that it can substitute for regulation “consistent with the protection of consumers.”

As of September, 2000, slightly more than 6% of all business and residential lines were served by

competitors, and these providers were resellers or bought UNE loops, making them dependent on AI's wholesale prices. In light of this limited competition, a primary issue is whether the Plan was appropriately designed to accommodate the level of competition that actually arose. Competition issues are further addressed in section III.4, addressing section 13-506.1(b)(3): whether the Plan responds appropriately to changes in the structure of the telecommunications industry that are, in fact, occurring.

GCI/City reach the same conclusion in this section as they reached in section III.4. Because competition has not developed to constrain prices, and many services were reclassified as competitive despite the absence of competition, the Plan relied on competition prematurely. The high total company returns and the high returns AI alleged for competitive services both demonstrate that competition is not yet capable of providing sufficient consumer protection and cannot be relied upon to substitute for regulation.

The HEPO does not address whether the Plan appropriately relied on competition to constrain prices, or discuss the level of competition. Instead, it concludes that “[w]e see no casual [sic] connection between the Plan the furtherance/hinderance of competition... [The] Plan simply does not have such powers.” HEPO at 51 (Section III.8). This conclusion ignores section 13-103(g) which provides that: “protection of the public interest requires changes in the regulation of telecommunications carriers and services to ensure, to the maximum feasible extent, the reasonable and timely development of effective competition in all telecommunications service markets.” It is therefore appropriate to consider whether the Plan has hampered or encouraged the development of effective competition.

The Commission has repeatedly expressed its dissatisfaction with the pace at which competition is developing in Illinois. AI argued that it invested “millions” in opening its market to competitors. However, “millions”, in the context of a \$3 billion investment, is so vague as to be meaningless. Further, the dearth of competition for local service combined with AI's repeated rate increases for services reclassified as competitive, shows that during the years the Plan has been in place, effective competition has not in fact developed.

The GCI/City Excetions conclude that during the Plan competition has not arisen to the extent that it can constrain prices or substitute for regulation, and that the Plan components that relied on competition to insure fair rates have not operated as the Commission intended. Further, effective competition for local service has not developed during the Plan, despite the legislative intent that the development of competition be a consideration in the adoption of alternative regulation.

9. Service quality

GCI/City do not object to the ultimate conclusion the HEPO that AI's service quality deteriorated under the Plan. However, GCI/City note that there were comments in the Commission Conclusion on this issue that reached beyond the issues presented. The proposed language in GCI/City's exceptions includes the HEPO's discussion of the parties' positions, but deletes certain statements of the Examiners.

10. The High Returns Received by the Company and the Many Shortcomings of the Plan Show That it has not Served the Public Interest, is not a More Appropriate Form of Regulation, and Requires Substantial Adjustment.

The HEPO concludes that Plan, while not perfect, has worked reasonably well, and constitutes a more appropriate form of regulation than rate of return regulation, and should be modified to serve the public interest. HEPO at 67 (section III.10). GCI/City submit that the Plan's shortcomings undermine the conclusion that the Plan has furthered the public interest or is a more appropriate form of regulation, as required by the Act. 220 ILCS 5/13-506.1(b)(1) and (4). GCI/City itemize deteriorating service quality for repair and installation of POTS; the unreasonably high returns on equity AI reported during the Plan, which have been calculated as up to 43% for a 1999 test year; the Company's concentration of rate reductions in volume discounts, while leaving residential network access and Band A and B usage rates virtually unchanged despite falling costs; the failure of competition to replace regulation; and the Company's misuse of the new services provision of the Plan all cause us to hesitate to find that the Plan has been or will continue to be in the public interest. GCI/City conclude that rate reinitialization, or a rate reduction consistent with the zone of reasonableness concept is necessary for the Plan to be considered "in the public interest." If rates continue to produce revenues that exceed investors' expectations, and that are so high above rates that would be set under rate of return regulation, it cannot be concluded that alternative regulation is a more appropriate form of regulation. The evidence in this review docket has shown that the current Plan provides an unreasonable benefit to shareholders at the expense of consumers of both noncompetitive and competitive services.

GCI/City's Exceptions state the above conclusions.

IV. RATE REBALANCING

GCI/ City agree with the Hearing Examiners' recommendation that Ameritech's petition to rebalance its rates be denied. HEPO at 83-84(section IV). While GCI/City agree with the HEPO that Ameritech has not shown any cost justification in the record to support an increase in the residential NAL, GCI/City submit that the HEPO fails to discuss and evaluate GCI/City witness Dunkel's analysis and corrections to Ameritech's cost study in detail.

Mr. Dunkel was the only witness to perform an extensive analysis of the company's costs. His analysis shows that the residential NAL exceeds costs by a significant margin. This is important because GCI/ City witness Dunkel's analysis provides cost support for a reduction of \$1.30 for the residential NAL rate. The Commission should be informed that the NAL rate can be reduced by \$1.30 and still exceed LRSIC. It is also important for the Commission to understand just how egregious Ameritech's cost study was in purporting to support a residential rate increase at a time when Ameritech has yet to remedy its gross service quality failures and when the company's return on equity exceeds 43%.

The HEPO also fails to evaluate and dismiss Ameritech's various non-cost, policy arguments for increasing residential rates. For example, Ameritech initially attempted to support its rate rebalancing proposal by asserting that the "low" NAL price was contributing to the minimal level of competition in the residential market. Ameritech later admitted that it didn't have any evidence to support this assertion and that the increase it was requesting would not have a significant impact on competitive entry. AI Ex. 1.2 at p. 33.

In this regard, GCI/City have provided language that expands upon the HEPO's rationale for rejecting Ameritech's Petition to rebalance rates.

V. GOING FORWARD

A. Existing Components of the Price Cap Formula

GCI/City made some language changes to this section to clarify how the price cap index works. These changes are included in GCI/City's Exceptions.

B. Proposed Modifications to the Price Cap Index

1. Measure of Inflation

GCI/City made minor language changes to this section, but have no substantive exceptions.

2. X Factor: The X Factor Was Set Too Low to Fairly Capture AI's Productivity and Cost Savings, and Should Be Increased to 6.5%.

GCI/City rewrote significant portions of this section of the HEPO because the HEPO did not fairly present GCI/City's position that the X factor has been too low to capture a reasonable portion of the productivity and cost savings AI realized over the course of the Plan. After evaluating the operation of the X-factor over the past six and a half years, GCI/City witness Dr. Lee Selwyn testified that it should be increased to 6.5% to be consistent with the productivity factor proposed by SBC and other ILECs and adopted by the FCC last year. 15 FCC Rec. 12962 (May 31, 2000)(CALLS Settlement). GCI Ex. 3.0 at 5-10, 25. The 6.5% offset is consistent with FCC studies that showed ILEC productivity on a company-wide basis (including both interstate and intrastate operations) to be between 5.5% and 8.51% and is considerably smaller than AI's actual productivity during the course of the plan. *Id.* at 25, 26. As a check on the reasonableness of the 6.5% offset, Dr. Selwyn calculated what productivity factor would have resulted in AI earning the authorized rate of return of 11.36%. His "implicit X-factor" analysis showed that AI's actual productivity during the course of the plan was 11.06%. GCI Ex. 3.0 at 26. This shows (1) that the 4.3% offset has been unreasonably low; (2) that a 6.5% productivity offset "is clearly within the realm of possibility for achievement for Ameritech Illinois"; and (3) the company could still achieve and retain the benefit of efficiencies beyond that 6.5% offset. GCI Ex. 3.0 at 26 and GCI Ex. 13 at 18.

Further, increasing the X factor to 6.5% is justified by AI's 43% return on equity and return on rate base of 28.49% as calculated by GCI/City witness Ralph Smith, and by AI's own reported return on rate base of 19.15% for intrastate operations (later reduced to 18.82%, Am. Ill. Ex. 7.3 at 5) and 23.89% for total company operations for 1999. GCI Ex. 3.0 at 16. The Company has reduced costs to the extent that a 6.5% X factor would still only reflect a little less than half of its annual, actual productivity.

The FCC's 6.5% factor incorporates a consumer productivity dividend, and represents a rate adjustment factor proposed by incumbent LECs, including SBC and Ameritech which was finally adopted by the FCC for a five year period. GCI Ex. 3.0 at 23-24. See also 15 FCC Rec 12962, 2000 FCC Lexis 2807. It operates identically to the X factor in the federal jurisdiction and in Illinois. GCI Ex. 13.0 at 15. Although the CALLS Settlement parties preferred to call it a "transitional mechanism" or a "rate reduction factor," the FCC accepted the 6.5% figure along with the BOCs terminology "to end the debate over the appropriate size of the X-factor now and for the next five

years.” *Id.*, quoting FCC Sixth Report and Order, 15 FCC Rec. 12962, para. 40. Regardless of the label put on the 6.5% X factor, it performs the same function in the FCC’s price cap index as the X factor performs in IBT’s price cap plan.

When the Commission adopted “pure price cap” regulation, it stated that results from other jurisdictions could be used as a frame of reference or to identify problem areas. Alt. Reg. Order at 35. The adoption of a 6.5% X factor would allow the Commission to take advantage of the work done in the federal jurisdiction where the ILECs agreed on an X factor, it was based on total company operations, and record evidence in this proceeding demonstrates that the ILEC proposed X factor is reasonable for the next five years. See GCI Ex. 3.0 at 22-29 and 13.0 at 14-18.

The HEPO accepts the productivity study presented by AI as the basis of the X factor despite the fact that the current 4.3% X factor has captured barely a quarter of AI’s cost savings during the life of the Plan. GCI/City recommend that the Commission reject that conclusion and adopt the 6.5% X factor recommended herein. GCI/City’s Exceptions incorporate the 6.5% X factor in section V.B.2.

3. Z Factor - The Commission Should Retain the Current Z Factor and Reject AI and Staff’s Suggestion to Maintain “Revenue Neutrality”, Encourage Multiple Filings and Limit Commission Discretion.

The HEPO’s conclusions about the Z factor, or exogenous change factor, are confused and require clarification. The HEPO would retain the Z factor, but require AI to make an exogenous treatment filing within 30 days of the exogenous event, together with the specific rates it wishes to change. It then requires “actual application of a Commission approved exogenous event on an annual basis.” It says that “parties will not be subjected to the additional regulatory burden of a new category of cases”, while appearing to require both 30 day filings and annual filing. In addition, a “Commission approved exogenous event” is never described, and appears to put the cart before the horse, as the Commission approval ordinarily comes after the Company’s application.

The HEPO further concludes that it is “arbitrary and inconsistent” to “automatically prohibit exogenous treatment for Commission mandated rate reductions.” Yet, there is no evidence that the Commission automatically prohibits exogenous treatment for mandated rate reductions. The Commission

has retained the discretion to consider that issue, and in fact, AI has presented it to the Commission at least twice for consideration. See ICC Docket 98-0601/0602 and 98-0335 (consolidated in this proceeding). See also ICC Docket 01-0302 (annual rate filing). It is erroneous to suggest that the Commission automatically prohibits exogenous treatment of mandated rate changes when the Commission has fully considered AI's request for revenue neutrality in the context of the actions brought by the Company during the course of the Plan.

The HEPO appears to try to adopt both AI's request for automatic exogenous treatment for mandated rate changes and Staff's suggestion that the Commission retain discretion to deny exogenous treatment. In doing so, it fails to convey to the Commission that AI's proposal is an effort to deny the Commission discretion and to maintain revenue neutrality, a concept associated with rate of return regulation. Further, the 30 day proposal would add a regulatory proceeding and the short time frame recommended by the HEPO would disadvantage intervening parties and Staff which will lack the time, data and resources to provide reasonable review of AI's request. The Z factor changes requested by AI would increase regulatory burdens and incorporate rate of return concepts, which in other contexts AI abhors.

GCI/City recommend that the existing Z factor rules remain unchanged. They provide reasonable guidance to the Commission and the parties on what may qualify for exogenous treatment, they retain Commission discretion to determine whether exogenous change treatment is necessary, and they limit consideration of exogenous changes to the annual rate filing.

GCI/City's Exceptions revise the language in the Order to retain the existing Z factor.

4. Service Quality Factor/Q Factor

GCI/City agree with the HEPO that the service quality penalty should be assessed outside the price index formula.

C. Pricing Flexibility and the Residential Rate Cap

Although GCI/City agree with the HEPO conclusion that the 2% pricing flexibility currently in the Plan should be continued, GCI/City maintain that section 13-506.1(c) requires that a cap on the residential network access line and band A usage be continued if alternative regulation is continued.

Conspicuously absent from the HEPO is any discussion of the need for a rate cap for basic residential services in the new or modified plan approved by the Commission. The Examiners' failure to address this issue ignores the plain language of Section 13-506.1(c) of the Act, which provides:

An alternative regulation plan approved under this Section shall provide, as a condition for Commission approval of the Plan, that for the first 3 years the plan is in effect, basic residence service rates shall be no higher than those rates in effect 180 days before the filing of the plan.⁵

220 ILCS 5/13-506.1(c). Unless a residential rate cap is included in the plan, even price changes falling within the existing 2% pricing flexibility would constitute illegal increases for basic residence service under 13-506.1(c).

In its Reply Brief in this docket, AI argued that the 13-506.1(c) rate cap provision, by its terms, is triggered once, and only once, when a company first files for approval of an alternative regulation plan. AI Reply Brief at 33. AI is wrong. In the Second District Appellate Court's review of the Commission's 1994 Price Cap Order, the Court referenced 13-506.1(c) and concluded "*any* plan adopted must maintain basic residential service rates for three years at the level in effect 180 days before the filing of the plan." Illinois Bell v. Illinois Commerce Commission (Illinois Bell II), 283 Ill. App. 3d 188 at 204 (emphasis added). The General Assembly specifically chose to use the phrase "any plan", and not "the first plan" when referencing the rate cap requirement. The canon of statutory construction which provides that statutes are to be interpreted in light of their "plain meaning" Id. dictates that the Commission impose, at a minimum, a rate cap for basic residence service rates for the first 3 years the plan approved in this docket is in effect.

The Court removed any doubt about when and how often the rate cap is to be implemented when it held: We consider section 13-506.1(c) to be a safeguard against *any plan* promulgated in violation of the standards created by the legislature. The minimum three-year moratorium on rate increases ensures that the legislature has the time to amend or rescind any Commission action taken pursuant to section 13-506.1 This protects against any errors the Commission may make in applying section 13-506.1's standards.

Illinois Bell II, 283 Ill. App. 3d at 204 (emphasis added). Here, the Court made clear its view that Section 13-506.1(c) protects ratepayers from Commission errors in the implementation of *any* alternative regulatory plan adopted by the Commission, not just the first plan. Moreover, it ultimately negates the issue of whether the plan approved by the Commission is characterized as "new" or "modified".

⁵ For purposes of this Section, "basic residence service rates" shall mean monthly recurring charges for the telecommunications carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges.

While the Act mandates that the residential rate cap be extended to residential access and untimed Band A usage charges, the record supports a continuation of the rate cap implemented by the Commission in its original Alt Reg Order, which extended the cap to Band B usage charges and increased its duration from three to five years.⁶ First, the conditions that caused the Commission to include the cap in the existing price cap plan in order to ensure that the requirements of Section 13-506.1(b) are met have not changed. Residential NAL and usage service (Bands A and B) remain noncompetitive services subject to negligible competitive threat. By including these services under a rate cap, and making the additional modifications to the formula recommended in this Brief, “the customers whose demands are the most inelastic” will, again, “be protected from the exercise of monopoly power during the pendency of this plan.” See Price Cap Order at 64. When combined with the rate reinitialization and modifications to the formula recommended by GCI/City, extension of the residential rate cap will help ensure that rates produced under the plan are “fair, just and reasonable”, as required under Section 13-506.1(b)(2) of the Act.

Second, the Commission’s concern with satisfying the statutory and policy goal of universal service has not changed in the six years since the price cap plan began. Indeed, the Commission’s concern with ensuring that residential service remain affordable for all customers should be heightened, given the decline in universal service Illinois has experienced during the life of the price cap plan. See GCI Ex. 8.0 (Dunkel Direct) at 6-11 and section II.i. above. The Commission’s recognition of the “general principle of microeconomics that customers with inelastic demands have access to fewer substitute products” still applies today. Id.

The principles of universal service embedded in the Act (see, e.g., Section 13-103(a), 13-506.1(a)) must be applied to the Commission’s consideration of how to craft the regulatory plan to be adopted in this docket.

When it issued the 1994 Price Cap Order, the Commission noted:

With respect to the price/cost disparity, we agree that it is unfortunate that some disparity also will be frozen in place, but we believe that the preservation of universal service represents a matter of public interest that overrides rigid adherence to pure cost-based pricing.

Price Cap Order at 65-66. Even if AI had shown that its residential rates were below cost⁷ or did not provide an

⁶ The Commission’s 1994 Price Cap Order also capped residential Band C usage rates. Because Band C usage now is a competitive service, no such cap would apply.

⁷ AI’s new cost of service model, which included the “LFAM” model, was rejected by Staff, thoroughly critiqued by GCI/City witness Dunkel, and found unreliable by the Examiners, as discussed elsewhere in this Brief on Exceptions. In addition, GCI/City witness Dunkel demonstrated that the NAL rate could be reduced by \$1.30 per month per line and still cover all loop costs. GCI/City Ex. 8.0 at **.

adequate return, which it did not, universal service concerns mandate that access rates remain capped. Further, in this review proceeding, these universal service concepts support the \$1.30 NAL rate reduction recommended by GCI/City.

Third, AI's arguments that residential rate increases would address alleged subsidies other services have provided to residential services, and allow competition to grow vigorously in the residential market, do not withstand scrutiny. AI Ex. 4.2 at 20-21. Mr. Dunkel's detailed study of the Company's cost of service studies, the current residential NAL rates are well above their long run service incremental cost ("LRSIC"). GCI Ex. 8.0 at 11-13 and rate rebalancing and cost of service discussions herein. Further, promoting "competition" by raising inelastic, noncompetitive network access line rates beyond the price required to cover costs would only promote inefficient competition at the expense of consumers. This could be seen as a subsidy from noncompetitive ratepayers to competitive carriers in violation of section 13-507, conflicts with this Commission's commitment to cost based rates, and is certainly bad public policy.

In GCI/City's Exceptions, a residential rate cap like the one currently in place is adopted for the life of the Plan. In addition, the GCI Exceptions remove the HEPO's statement that "AI's argument relative to costs being at least at their long run service incremental cost is compelling." This statement is contradicted by the HEPO's conclusion that AI's cost of service study was not reliable and could not be used to support its claim that residential network access rates were below LRSIC. It is illogical to find an argument that is not supported by the record "compelling." GCI/City remove that statement from the Commission conclusions and make other editorial changes on the attached Exceptions.

**D. Proposed New Component Merger Related Savings/M Factor
The Commission Should Adopt the Approach of GCI/City on Merger Related Savings and Add a M Factor to the Formula.**

The HEPO disregards the record evidence which shows that a further delay in distributing merger savings poses a substantial risk that consumers will never realize the Commission's promise that they share in merger savings. The HEPO provided that the merger conditions shall remain in effect until the Commission completes the review of the annual filing for 2003. The HEPO stated: "The extent of actual merger related savings will be known in time for the Company's annual filing on April 1, 2004, at which time a one-time adjustment to the price cap index

should then be made.” HEPO at 85-86; V. D.

The HEPO should be modified to adopt an “M-factor” in the price cap formula to reflect merger savings as recommended by Dr. Selwyn. This will ensure that consumers realize savings in a timely manner, and the AI will have an incentive to address merger savings promptly and directly. Dr. Selwyn stated: “Use of an ‘M-factor’ to reflect merger savings would guarantee flow-through of those savings by further reducing the PCI, and would provide Ameritech Illinois the incentive to achieve the levels of merger savings that had been projected. ... This one-time adjustment should be made at the outset of any new or extended price cap plan, so as to permanently reduce the PCI by the 4.8% M-factor.” GCI Ex. 3.0 at 39-40 (Selwyn).

This factor and the PCI could be adjusted if the Commission determines that a different M-factor should be applied after the Commission investigation of actual merger savings is completed. GCI Ex. 3.0 at 40 (Selwyn). As the M-factor proposed by GCI/City can be adjusted at any annual rate filing, Staff’s and the Company’s argument that the Commission should wait until there is more complete information has been addressed.

The Commission, in its review of the Ameritech-SBC merger, provided that savings and costs be tracked and that information be provided in the annual rate filings until an updated price cap formula has been developed in this proceeding. See: ICC Docket No. 98-0555, Order at 148-149. After all, the Commission was required to address savings as part of its review of SBC and Ameritech’s merger. See 220 ILCS 5/7-204(c). By adopting an M factor, the Commission will ensure that ratepayers actually receive a share of merger savings, whereas under the HEPO’s recommendation, consumers would continue to wait years before receiving any savings benefit and before final resolution of the savings issue. Further, in the Merger Order the Commission clearly intended that a mechanism to flow through savings to consumers would be established in this docket -- not in a future review docket years in the future. ICC Docket 98-0555, Order at 149 (Sept. 23, 1999).

Even AI maintains that there are risks associated with waiting too long to distribute merger savings. Ai contends that net savings should be based on 2002 operations, and notes in its testimony: “To wait longer would not be in either the customers or Company’s best interest. Also, it will be more difficult to identify what savings are merger related and what savings are as a result of external changes as more time passes.” AI Ex. 3.1 at 20 (O’Brien). Clearly, if ratepayers do not receive their share of merger savings in a timely fashion, it will become more difficult to accurately account for the savings.

In conclusion, GCI/City urge the Commission to ensure that ratepayers receive their share appropriate share of merger savings in a timely fashion and that the Commission adopt the “M” factor presented in Dr. Selwyn’s testimony. GCI/City’s Exceptions provide language adopting an M factor as recommended above.

E. Baskets

2. Proposed Modifications to the Basket Structure

a. Consolidation of Baskets

GCI/City agree with the HEPO that the four basket structure should be continued and that AI’s request for basket consolidation should be rejected.

b. Calling Plans and New Services

The HEPO discusses the issues raised by Staff and GCI/City about which basket AI’s residential calling plans (Simplifive and Call Pack) should be in, but fails to address the more fundamental issue of how new services should be defined and treated. GCI/City except to the HEPO’s conclusion that residential calling plans like Simplifive and Call Pack that merely reprice existing services in the residential basket (usage in Bands A and B) be treated as “new services” and placed in the Other basket.

Under the Plan, new services are not subject to the pricing constraints of the plan when initially offered, and after one year, are brought into the plan at the new, repackaged rate. When existing services are repriced as new services, they can be priced higher than the price cap would have allowed for the underlying, non-competitive service. GCI Ex. 1.0 at 64-67. AI has skirted the basket structure by treating price changes to band A and B usage, which were expressly placed in the Residence basket, as “new services” and then placing them in the “other” basket at a higher price. GCI Ex. 1.0 at 65.

To avoid this manipulation of the Plan, new services should be expressly defined as services that have not been previously available to consumers. The Commission should insure that existing non-competitive services that are repackaged or bundled with other services are not priced without regard to the price cap. The new services provision was intended to encourage the development of new services and to allow new noncompetitive services to be priced without regard to the price cap. If existing noncompetitive services can be priced without regard to the price cap, the Plan protections will be undermined and diminished.

AI has used the new services provisions to generate additional revenue above what the Plan would have

allowed had the services remained in the Residential basket. Indeed, more than 90% of the “new services” revenues come from calling plans that price Band A and B usage above price cap levels.

GCI/City request that the Commission set the “new services” rules to require that only services not previously available to consumers be offered as new services, and that existing services, even if repackaged or bundled, be subject to the price cap applicable to the basket they were in when the Plan was originally approved in 1994. This will require that the Simplifive, CallPack and Anytime rates be transferred back to the Residence basket. GCI/City submit proposed language to this effect in their Exceptions, Commission Conclusion to section V.E.

d. Reinitialization of the API & PCI

The HEPO rejects Staff and GCI/City’s recommendation that the API and PCI be reset to 100, because reinitialization will “effectively eliminate the headroom” AI achieved during the Plan. This conclusion fails to recognize that the initial Plan was set for a five year term, and that this review is effectively a new plan. By reinitializing the API and PCI to 100, the Commission will give the Plan the maximum potential to affect rates.

GCI/City changed the Commission Analysis and Conclusion to reflect a return of the API and PCI to 100.
F. GCI/City Urge the Commission to Adopt Earnings Sharing in the Alternative, to Replace Rate Reinitialization.

GCI/City witness Charlotte TerKuerst described an earnings sharing plan to replace the current price cap. The HEPO declines to adopt earnings sharing, but it also fails to properly analyze AI’s earnings or GCI/City’s rate reinitialization request. GCI/City do not except to the rejection of earnings sharing, provided that rates are reinitialized to fair, just and reasonable levels. Earnings sharing provides an ongoing review of earnings to insure that the staggeringly high rates of return evident over the last few years are shared with ratepayers. In the absence of earnings sharing, rate reinitialization is compelling and required to maintain just and reasonable rates.

The attached Exceptions do not change the discussion of earnings sharing, because they conclude that AI’s rates must be reinitialized to just and reasonable levels.

G. GCI/City Agree That Monitoring and Reporting Requirements Should Be Retained.

GCI/City agree that the monitoring and reporting requirements contained in the Plan should be continued.

H. The Commission Should Adopt the One-time Credits Proposed by Staff Because They

Correct for Past Plan Abuses.

The Staff proposed two one-time credits to correct for actions which it concluded AI took in violation of the Plan or the law. Staff argued that AI miscalculated its installation within 5 business days benchmark and so avoided the .25% service quality adjustment for several years. It also maintains that AI improperly removed certain residential services from the Plan through a competitive reclassification which it later voluntarily reversed. A second one-time credit would restore the reductions that would have resulted from having these services under the price cap. The HEPO declines to adopt these one time credits.

GCI/City support Staff's recommendation for these credits, and their Exceptions adopt them.

I. The Commission Should Adopt the Reclassification Penalties Proposed by GCI/City and Staff.

Under the Plan, the incentive to reclassify services as competitive before the advent of price constraining competition is great. A service classified as competitive is not subject to the price cap limitations, and prices can be increased on one day notice. GCI/City and Staff argued that a financial disincentive to premature or improper reclassifications would counter the existing financial incentives to remove a service from the price cap through reclassification and then raise its rate unconstrained by the price cap, an earnings review or competition. A \$10,000 per day adjustment, accumulating from the effective date of reclassification until the effective date of reclassification back to non-competitive status, would be paid or credited to retail and wholesale customers, carriers and interexchange carriers based on the relative gross revenues IBT derives from those various customer classes. GCI Ex. 1.0 at 32. This remedy would be in addition to the refund authorized by section 13-502(d) of the PUA, and is specifically designed to counter the perverse incentive to premature and unwarranted reclassification evident in the current plan.

The Proposed Order rejects the reclassification penalty. GCI/City except to that conclusion and submit proposed language reaching a different conclusion in their Exceptions.

VI. RATE REINITIALIZATION

A. Contrary to the Examiners' Conclusion, Earnings Under Alternative Regulation Are Relevant.

In their analysis of whether rates should be reinitialized, the Examiners again refer to Staff's proposed "zone of reasonableness" as the benchmark for the issue of whether rates should be reinitialized. The Examiners also assert that because the Proposed Order amounts to a fine-tuning of the existing Price Cap plan, and not "a switch to an entirely different type of plan", the notion of reinitializing rates, as occurred back in 1994, is "unavailing". HEPO at Section VI, par. 5. The Examiners write:

What was a rational and necessary move by the Commission at the initiation or the "establishment" of the Plan, when AI was still under ROR regulation, is not viable at this juncture where ROR has long been abandoned in favor of alternative regulation.

Id. at Section VI, par. 4.

Like their discussion in that portion of the HEPO examining whether rates are "fair, just and reasonable", the Examiners offer an inherently conflicting rationale for denying GCI/City's rate reinitialization demand. On the one hand, the Examiners embrace Staff's "zone of reasonableness" argument, which is rooted in an examination of earnings, as a basis for denying rate reinitialization. Id. On the other hand, however, the Examiners argue that rate reinitialization is no longer an option because the Commission abandoned an examination of earnings as a basis for evaluating the justness and reasonableness of rates when it adopted price caps regulation back in 1994. Id. This logic is flawed and should be rejected in favor of rate reinitialization.

First, the notion that reinitialization "is inconsistent with the principle of alternative regulation" (Id. at Section VI, par. 9) necessarily implies that upon its approval of price cap regulation in 1994, the Commission forever abandoned the examination of earnings in order to determine whether rates are fair, just and reasonable. This conclusion contradicts the plain reading of Section 13-506.1 of the Act, the Illinois Appellate Court's interpretation of that statute, and the Commission's own 1994 Price Cap Order. For example, Section 13-506.1(f), which provides that "[n]othing in this Section shall be construed to authorize the Commission to render Sections 9-241, 9-250 and 13-505.2 inapplicable to noncompetitive services", has been interpreted by the Illinois Appellate Court in its review of the Commission's Price Cap Order to ensure "that preexisting safeguards against discriminatory or unjust rates are not subject to implied repeal." Illinois Bell Telephone Company v. Illinois Commerce Comm'n, 283 Ill. App. 3d 188, Slip op. at 9 (2d Dist. 1996) ("Illinois Bell II"). Moreover, the Court in Illinois Bell II viewed Section 13-506.1 as "a tool to move the telecommunications industry from monopoly to market." Illinois Bell II, Slip op. at 10.

The Court's characterization of Section 13-506.1 as a tool that would help develop competition in the local market coincides with the Commission's hope, expressed in the 1994 Price Cap Order, that alternative regulation was a mechanism that would not only lead "toward a successful transition to a more competitive environment", but would also "protect the interests of all interested parties." Price Cap Order at 19. Moreover, the Court's characterization of the plan is particularly relevant to the Commission's determination of how to analyze whether the rates produced under an existing or new alternative regulatory plan are fair, just and reasonable. Had alternative regulation worked as the Legislature, the Appellate Court and the Commission envisioned, and thereby succeeded "as a tool to protect ratepayers during the move in the telecommunications industry from monopoly to market", the record evidence would have revealed the existence of competitors vying for the local residential market, with real, price-constraining competition and a choice of local service providers for ratepayers. Under that scenario, an earnings examination would reasonably be expected to show that earnings remained within a "zone of reasonableness" during the Plan, and that the interests of ratepayers and shareholders remained in balance.

That state of affairs, however, did not develop as the record evidence shows, and the Examiners themselves acknowledged in the HEPO¹. As such, establishing a new, modified alternative regulation plan necessarily requires a (1) a recognition that the going forward rates are being established for what must still be described as a monopoly local service market, and (2) given the absence of competition, a traditional earnings analysis is useful, if not necessary, to evaluate whether the rates set under the alternative regulatory plan are, in fact, fair, just and reasonable. Section 13-506.1(b)(2) demands no less.

Indeed, given the lack of competitive entry into the residential local service market, it is not enough, as the Examiners espouse, to acknowledge that "rates have declined under the Plan's operation, which means that the formula has worked to our expectations." HEPO at Section VI, par. 4. This mindset necessarily assumes that the Company's financial condition and the cost of providing noncompetitive telecommunications service has remained frozen in time since 1994, when the first Price Cap Order was approved. Moreover, given that the going-in rates for the 1994 Order were based on a September, 1991, through August, 1992, test year, it is fair to say that the Examiner's resistance to revisit the rates in question assumes static conditions over nearly a decade. Of course, both common sense and the record evidence reveal that much has changed since 1994, including (1) declining cost trends in the telecommunications industry, (2) increased access line growth and unprecedented demand for vertical

¹ See HEPO at Section III, subsection 8, par. 2, Section III, subsection 10, par. 2.

services, (3) record Company profits, (4) a decline in AI investment in network operations during the Plan, and (5) a precipitous drop in the quality of basic telephone service. What may have been a reasonable starting point for rates nearly a decade ago, with less than significant annual reductions in the price of plain old telephone service since that time, can no longer be assumed to be the appropriate basis for generating fair, just and reasonable rates on a going-forward basis.

Indeed, the fact that the Examiners appear to have embraced the “zone of reasonableness” argument as a basis for concluding that AI’s rates are fair, just and reasonable presupposes the relevance of an earnings examination. In fact, when the Commission approved the AI price cap plan, it specifically noted that it was not abandoning the future examination of the Company’s costs and earnings as a result of its adoption of alternative regulation:

(t)he Company should not interpret our endorsement of an alternative regulation plan as an abandonment of our long-standing commitment to marginal cost-based prices. The Commission wishes to make clear that by approving an alternative regulation plan, we will not abdicate our responsibility to scrutinize the pricing practices of the Company, and we will suspend proposed price changes where warranted, even if the proposed price changes are in technical compliance with the price regulation formula.

Alt Reg Order at 71. Moreover, the Commission specifically highlighted the continued usefulness of earnings information in determining whether the plan has established just and reasonable rates at the time it approved the plan: “Unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective.” *Id.* at 92. Clearly, the Commission viewed earnings data as an important indicator of how well the plan is working.

B. AI’s Earnings Are Excessive Under Any “Zone of Reasonableness Test

GCI/City also take exception to the Examiners conclusion that “We are only presented with the proposition that- (sic) earnings are higher than initially authorized and hence rates must be unreasonable.” HEPO at Section VI, par. 6. This assertion is wrong for two reasons. First, GCI/City have never asserted that earnings higher than that originally authorized are *per se* unreasonable. Second, the record contains no less than three separate analyses of

AI's earnings, all showing that the earnings realized by AI are between 1,618 and 1,797 basis points more than the reasonable cost of capital. See above discussion of just and reasonable rates. These high earnings are excessive by any measure and, justify the reinitialization of rates.

While GCI/City recognize that the Plan permits the Company to earn profits in excess of its allowed rate of return, no provision in the Alt Reg Order or Section 13-506.1 of the Act in any way suggests that the regulatory compact inherent in the approval of alternative regulation includes an open-ended right to unlimited earnings, such as the excessive 43% return on equity achieved by AI in the 1999 test year. Instead, the Alt Reg Order includes numerous provisions that reflect the Commission's desire to cautiously monitor the plan and the Company's earnings in order to assess the Plan's performance. For example, the Commission specifically wrote, after rejecting an earnings-sharing component in the first plan:

The Commission's decision to exclude express earnings sharing from the alternative regulation plan approved in this proceeding is not to be construed as a rejection of all earnings sharing mechanisms of the future. This is the initial alternative regulatory plan for telecommunications in Illinois. The Commission will, in its future review proceedings, entertain evidence and argument of policy considerations for the provision of some forms of earnings sharing in a revised plan.

Alt Reg Order at 51. While this pronouncement in no way guaranteed that the Commission would adopt earnings sharing at its five-year review of the plan, it did make clear that the Commission would be (1) monitoring the Company's earnings in order to determine whether rates set under the plan were just and reasonable, and (2) entertaining evidence from parties during the review proceeding that earnings sharing was needed and appropriate. Thus, contrary to the Examiner's terse conclusion, it is not enough to simply determine whether the plan produced annual rate reductions for the Commission to determine that "the formula has worked to our expectations." HEPO at Section VI, par. 4.

Mindful that it was launching a novel regulatory approach to setting rates for AI, the Commission also wrote back in 1994:

Finally, although we are confident in our endeavor to fashion an innovative plan of action to meet the demands of the future, uncertainty always accompanies change. As such, any alternative form of regulation must be carefully monitored to ensure that its intended effects are being realized.

Alt Reg Order at 19. Indeed, this Commission's language suggests a more studied approach than the HEPO provides to the determination of whether rates set under the Plan are just and reasonable.

GCI/City witness TerKeurst pointed out that one would expect that AI would be quick to seek

modification of an alternative regulation plan if earnings fell unacceptably low. Id. at 12. Consumers likewise are entitled to demand modification -- in this instance, rate reinitialization -- given the excessive earnings amassed by AI during the life of the Plan. The zone of reasonable test accommodates both ends of the spectrum.

Upon recognizing the relevance of earnings in the determination of whether rates are just and reasonable, the next question under the “zone of reasonableness” approach is whether AI’s earnings reach the level of excessiveness that justifies rate reinitialization. Whether the Commission accepts the Company’s unadjusted operating income statement, which puts its profit level at 24.5%, the Staff’s adjusted operating income analysis, which reports AI’s profit level to be 40.1 %, GCI/City’s adjusted operating income analysis, which reports AI’s profit level to be 43%, or some level in-between, all of the evidentiary numbers reveal a level of earnings that demands the reinitialization of rates in order to satisfy the just and reasonable requirement of Section 13-506.2(b).

For example, assuming the Commission accepts AI’s position that it earned an understated 24.5% on common equity during the 1999 test year, this *still* amounts to an excessive earnings level in need of rate reinitialization. This level is more than *double* the cost of common equity of 11.30% approved by the Commission at page 175 of the Price Cap Order and is close to double the 11.80-14.40% and 11.86 - 12.71% return on equity recommended by Staff and AI witnesses respectively. *See also* GCI/City Ex. 6.2 (Smith Rebuttal) at 5; Staff Ex. 11; AI Ex. 6.

While the Commission envisioned the Company would achieve earnings in excess of its allowed return when it approved the Plan, it is unreasonable, and unsupportable in fact or law, to assume that the Commission assumed the Company would more than double the profit level the Commission deemed appropriate when it started the plan and the current cost of capital. This is especially the case given the conclusions in the 1994 Order, referenced above, that point to an interest in proceeding cautiously with alternative regulation and with an eye toward monitoring earnings under the novel plan.

The conclusion that even the Company’s significantly understated assessment of its test year earnings level triggers a need for rate reinitialization is buttressed by record evidence of recently adopted cost of equity rates for incumbent LECs in other jurisdictions, as well as the Company’s and Staff’s assessments in this docket of what constitutes an appropriate return on equity for AI on a going-forward basis. For example, as reported in GCI/City witness Smith’s rebuttal testimony, the adopted cost of equity figures for three incumbent LECs in recent proceedings before state commissions established ROEs of between 11.0 and 11.75%. GCI/City Ex. 6.2 (Smith

Rebuttal) at 52.

Moreover, in this docket, even the Company's own assessment of what constituted a reasonable investor-required return on AI's common equity ranged from 11.86 percent to 12.71 percent. AI's reported, unadjusted test year 24.5% ROE is more than double either the low end or the mid-point of its own estimate of what constitutes a reasonable return on equity. If the Commission adopts either Staff's or GCI/City's test year operating income/earnings assessment, the Company's earnings are more than three and three-and-a-half times respectively what the Company considers to be a fair return on equity.

Staff witnesses also provided their own estimates of what constituted a reasonable investor-required return on equity for AI. For example, Staff witness Alan Pregozan testified that a reasonable investor-required return on AI's common equity ranges from 11.80% to 14.40%. Staff Ex. 13. AI's unadjusted, reported 24.5% ROE is nearly double the midpoint of Staff's generous ROE estimated range, and is more than double Staff's 11.80% recommendation. Moreover, should the Commission adopts Staff's operating income analysis, the Company's earnings are more than three times what Staff considers to be a reasonable, investor-required AI return on equity. Likewise, if the Commission endorses GCI/City's revenue requirements assessment, the Company's earnings are more than three-and-a-half times Staff's lower-end proposed return on equity. See GCI/City Ex. 6.2.

Given this data, it is incomprehensible that the Examiners could make the leap in logic that merely because rate reductions occurred under the existing price cap plan, existing rates are, therefore, just and reasonable. Nor is it accurate to contend, as the Examiners do, that "There is no showing that rates are unfair, unjust or unreasonable through any type of reasoned analysis." HEPO at Section VI, par. 6. Staff and GCI/City submitted extensive and detailed testimony from accounting witnesses and engineers that showed needed adjustments to the Company's test year operating income statement in order to reflect the Company's true revenue requirement on a going-forward basis. All of these proposed adjustments are discussed in Section VII (Revenue Requirement) of the GCI/City Exceptions. The Examiners did not even reference this record evidence.

It is worth noting, too, that the Examiners' conclusion that there was "no showing that rates are unfair, unjust or unreasonable through any type of reasoned analysis" implies that the burden was on intervenors to show unreasonableness, rather than on the Company to show reasonableness of rates. The Illinois Supreme Court has held that "Requiring intervenors to establish unreasonableness is no substitute for requiring proof of reasonableness." People ex rel. Hartigan v. ICC, 117 Ill. 2d 120, 135-136. (1987). Contrary to the analytical approach adopted by the

Examiners, the Commission must not act as just an arbiter, deciding which party presented the stronger argument, when it comes to making a finding as to whether rates under a plan are just and reasonable. Section 13-506.1 of the Act in no way negated the legal precept that the utility bears the burden of proving that its proposed rates are just and reasonable. 220 ILCS 5/9-201(c).

The Examiners conclusions in this section contain other misstatements of law and fact. The Examiners assert that “An increase in earnings was not unexpected just as a reduction in rates was expected.” HEPO at Section VI, par. 7. GCI/City do not disagree with this assertion. What the Examiners failed to analyze, however, is whether the level of earnings achieved by AI under the plan was excessive and, therefore, generated rates that are not just and reasonable. Again, the Examiners stop short of this needed analysis.

The Examiners then offer the unsupported nonsequitur that “we do not see AI being able to manage either costs or earnings nearly as effectively in the near term.” HEPO at Section VI, par. 8. First, there was no evidence offered about AI’s ability to manage its costs or earnings in the near term. Second, whether AI’s is able to continue to achieve the staggeringly high earnings it now achieves in the future is irrelevant to the question of whether existing rates are just and reasonable and in need of reinitialization.

C. Rate Reinitialization Does Not “Rewind” AI Profits

The Commission further contends that reinitialization “would effectively stop the Plan, rewind it under ROR regulation, and then run the Plan again” – a process the Examiners find to be irrational. HEPO at Section VI, par. 10. This statement betrays the fundamental flaw in the Examiners logic against rate reinitialization – that somehow, the Company became entitled upon the initial approval of price cap regulation to keep all profits over and above the initial going-in earnings level forever. This core assumption conflicts with the Act’s requirement that rates under *any* regulatory plan – whether traditional or alternative – produce just and reasonable rates. This fundamental precept of regulation does not disappear merely because the plan being reviewed is an alternative regulatory paradigm.

Moreover, the Examiners choice of the words “stop” and “rewind” also implies they believe that reinitializing rates somehow constitutes a taking or rebate of the profits AI earned since 1994. Of course, this is not the case. Rate reinitialization does not “reach back” to capture profits earned since the Plan began. Rather, it merely ensures rates on a going-forward basis reflect fair, just and reasonable levels.

D. Whether the Plan Is Characterized As “New” of “Modified” Is Irrelevant to the Question of Whether Rates Should Be Reinitialized.

Another point raised by the Examiners in their cursory rejection of rate reinitialization is their insistence that “GCI/City fail to realize that this is not a ‘new’ plan, and certainly not in the sense that our 1994 Order established a ‘new’ plan.” HEPO at Section VI, par. 3. Indeed, it appears that the assumption that the Plan produced at the end of this docket is not a “new” plan is a cornerstone of the Examiners refusal to even consider rate reinitialization. Specifically, the Examiners write:

To be sure, if the Commission was considering a switch to an entirely different type of plan, with a new and different set of components, the GCI/City position might have some validity. That, however, is not the case. Each and every one of the proposals before us addresses the Plan much as it is, with only relatively modest adjustments thereto. Thus, the attempt by the GCI/City to compare the Commission’s 1994 action in setting rates for the initiation of the Plan to the instant situation where we review the continuing operation of the Plan to make it better and more responsive, is unavailing.

HEPO at Section VI, par. 5. GCI/City submit that the labeling of the plan produced at the conclusion of this docket, whether it be called “new” or “modified”, is unimportant to the question of whether AI’s rates need to be reinitialized. All parties know this to be true: it is virtually a certainty that the rate-setting plan approved by the Commission this summer will not be identical to the plan approved in 1994. Whether the Commission adopts all or none of the provisions of the HEPO, the plan that will be put in place must satisfy, among other statutory criteria, the directive that rates be fair, just and reasonable.

E. The Goal of Creating A Competitive Marketplace Does Not Supersede the Commission’s Duty To Establish Just and Reasonable Rates.

Finally, the Examiners opine in their conclusion in this portion of the HEPO that “rate reinitialization may impact negatively on the growth of competition which is one of the alternative regulation goals to be considered under the Act.” HEPO at Section VI, par. 9. This rationale for rejecting rate reinitialization is a quintessential example of “missing the forest for the trees.” As noted above where section 13-506.1(b)(3) and competition in general are discussed, section 13-103(b) provides that “consistent with the protection of consumers of telecommunications services and the furtherance of other public interest goals, competition in all telecommunications markets should be pursued as a substitute for regulation ... to the extent consistent with the furtherance of market competition and the protection of the public interest.” Section 13-102(e) states that a key legislative goal for the development of competition in local telephone service markets is to ensure that the economic benefits are realized as soon as possible. 220 ILCS 5/13-102(e). Moreover, the General Assembly established as

the policy of the State of Illinois that consumers of telecommunications services should be required to pay only reasonable and non-discriminatory rates (220 ILCS 5/13-103(d)), and that “telecommunications services should be available to all Illinois citizens at just, reasonable and affordable rates.” 220 ILCS 5/13-103(a). The Examiners conclusion that rate reinitialization might dampen the growth of competition commits the very error the Examiners erroneously accuse GCI/City of committing in section III.8 of their HEPO: assuming the plan has the power to either encourage or discourage competition. Further, it implicitly assumes that rates should remain artificially high so that potential competitors can enter the market and, perhaps, offer lower rates than the incumbent carrier. The theory that low rates might discourage competitors from entering the market wrongly anticipates that ratepayers should subsidize the development of a competitive local market and that competition is an end in itself even if it fails to offer consumers protection from unreasonably high rates. Neither the appellate court, in its interpretation of Section 13-506.1 in Illinois Bell II, nor the Commission, in its approval of the first price cap plan in 1994, articulated such ratepayer subsidization of a competitive market as a goal for alternative regulation. Furthermore, such subsidization would be unlawful under section 13-507 of the Act.

The Examiners’ rationale against rate reinitialization is not based in law or fact and should be rejected, and the Exceptions submitted by GCI/City should be adopted.

VII. SERVICE QUALITY

A. The Statutory Standard

The evidence shows that customers were on the losing side of the equation when it came to receiving adequate performance levels in the service quality areas that matter most – POTS installation and POTS restoration (OOS>24). In addition, the evidence shows that the Company’s performance in other critical customer performance areas not measured under the plan yet important to ratepayers, such as customer call center answer times and keeping installation and repair appointments, declined under the plan. The evidence has shown, as detailed in the CUB and AG Initial Briefs and in the GCI/City Reply Brief, that the existing service quality measures, benchmarks and penalty mechanism have been inadequate in incenting the Company to “at a minimum, maintain the quality and availability of telecommunications services”, as required under Section 13-506.1(b)(6) of the Act.

In their Proposed Order, the Examiners conclude that, in terms of meeting the statutory directive that the plan “at a minimum, ... will maintain the quality and availability of telecommunications services”, the

objective is “to have the Company maintain service quality at an acceptable level.” HEPO at Section VII, subsection C.

GCI’s position is and always has been that the service quality benchmarks and penalty provisions in the existing plan are inadequate to incent IBT to maintain service quality for noncompetitive services, given the Commission-acknowledged inducements in price cap regulation to “reduce expenditures in certain areas in such a manner as to impact service quality adversely.” Alt. Reg. Order at 58. Both Ms. TerKeurst’s and Staff’s service quality proposals to revise the measures and penalty provisions of the plan are designed to improve Company service quality performance in critical areas only to the extent that performance has been *substandard* during the life of the Plan. To the extent that the Company has accepted the addition on new service quality measures on a going forward basis is an acknowledgment that Staff’s and GCI’s proposals to add several new service quality measures to the price cap plan fits in with the notion of “maintaining” service quality.

That being said, however, Section 13-506.1(b)(6) states that the Commission “may approve the plan or modified plan and authorize its implementation only if it finds, after notice and hearing, that the plan or modified plan *at a minimum* will maintain the quality and availability of telecommunications services.” 220 ILCS 5/13-506.1(b)(6) (emphasis added). Accordingly, contrary to IBT’s assessment, it would not be unreasonable or illegal for the Commission to adopt service quality benchmarks aimed at improving performance, particularly in those areas where service quality performance has been lacking or declining. For example, given the Company’s well-documented service quality failures, the Commission could appropriately determine that attaining improved service quality performance is “in the public interest”, pursuant to Section 13-506.1(b)(1). Moreover, as noted by Ms. TerKeurst, what constitutes acceptable service quality is a fluid concept. For example, technological advances may make prior service quality standards inadequate or outmoded, as illustrated by the proposed deletion of dial tone and operator intercept measures from the service quality mechanism. In addition, the mere maintenance of prior service quality levels may not always be adequate to ensure that the approved regulatory plan responds to changes in technology or encourages innovation in services, as contemplated by Section 13-506.1 of the Act. GCI/City Ex. 12.0 at 25. That being said, the Examiners’ vague objective to “maintain service quality at an acceptable level” fails to recognize the Commission’s ability to attaining improved service quality performance is “in the public

interest”, pursuant to Section 13-506.1(b)(1). In order to redress IBT’s service quality problems, the Commission must create a financial incentive for the Company to meet service quality benchmarks. In addition, the number of measures themselves must be expanded to truly reflect areas of customer concern, and the benchmarks must be set high enough to incite performance from the Company that “at a minimum will maintain the quality and availability of telecommunications services.”

B. Developing Benchmarks

In the HEPO, the Examiners adopt AI’s recommendation to set benchmarks for the designated service quality measures based on the Company’s average service quality performance over the last five years. HEPO at Section VII, Subsection C. The Examiners also conclude that where inadequate data exist or where the Company’s performance over the five-year period does not meet the minimum standards of service reflected in the Commission’s Par 730 rules, the Examiners adopt the standards in the Part 730 rules. Id.

The Examiners assert that using five years of data “better accounts for year-to-year and seasonal variations in conditions that affect service quality performance.” Id. GCI/City urge the Commission to reject this conclusion and rationale for several reasons. First, contrary to the Company’s position that the goal of maintaining service quality would be achieved by maintaining service quality at levels that have occurred *since* the plan’s inception, the evaluation of service quality should compare service quality before and after the plan’s implementation. This point is especially relevant to the Commission’s decision as to what benchmarks should be established for the measures included in the plan. IBT’s proposal to set benchmarks based on service quality levels achieved from 1995-1999 effectively locks degraded service quality performance into place as threshold levels.

As noted by GCI/City witness TerKeurst, such a plan would allow IBT’s inadequate performance to continue with no hope of or incentive for a return to even the best year under alternative regulation. GCI/City Ex. 12.0 at 25-26. This outcome is particularly inappropriate given the Company’s substandard performance under the plan. Moreover, it puts IBT in the position of setting its own benchmarks for service quality performance. Id.

In addition, the Company’s proposal to set benchmarks based on the average service quality performance over the last five years is inconsistent with Ameritech Illinois’ own recognition of its inadequate

service quality performance during several of those years. For example, Mr. Hudzik conceded that IBT's performance for Average Speed of Answer declined significantly between 1997 and mid-1999. Mr. Hudzik also concedes that IBT's installation and repair performance was inadequate during 1999 and 2000. AI Ex. 12.0 at 7-8. He also acknowledged that the Company has had problems keeping repair and installation appointments. Id. at 10. It is internally inconsistent for the Company to acknowledge some degradation in its service quality since the inception of the plan and then request that this degradation become the benchmark for evaluating whether service quality is maintained in the years to come. GCI/City Ex. 12.0 at 26.

As noted by Ms. TerKeurst, the Commission should adopt benchmarks for each individual service quality measure based on pre-plan levels, taking into account any other relevant factors. GCI/City Ex. 12.0 at 27. If pre-plan data is unavailable or otherwise inappropriate, the Company's own internal targets, should be used. For measures where the Company's performance during the 1995-2000 timeframe is the only source available, a benchmark generally should be based on the one year since the plan's inception that IBT's performance with regard to that particular measure was at its best. Id. To do otherwise, such as the Company and Staff recommend for purposes of setting benchmarks, ensures that service quality standards are locked in at less-than-adequate levels.

C. The Performance Measure and Benchmark Changes

1. Installation Within 5 Days

In their conclusion regarding the Installation Within 5 Days benchmark, the Examiners correctly find that the measure shall exclude order that are limited to vertical services. HEPO at Section VII, subsection D.1. However, they also assert that because no definitive evidence exists on the extent of the growth in vertical services before or during the Price Cap plan, it is "fair to re-set the benchmark." Id. Currently, AI is required to install 95.44% of all regular service orders within 5 days in order to avoid a service quality penalty. The Examiners' HEPO resets this benchmark to 90%, consistent with the minimum standard in the Commission's Part 730 rules, because "available data for the measure, as we here define it, does not establish a performance level consistent with the standard in our Part 730 rules, i.e. 90%." Id.

The Examiners conclusion in this regard should be rejected. Lowering the benchmark because AI has failed to meet even the minimum service quality standard on regular service installations is inconsistent with the statutory requirement that service quality be, at a minimum, maintained under the plan. Moreover,

as noted earlier in this Brief, the Company's performance in the Installation Within 5 days category has been woefully inadequate in recent years. It is counterintuitive for the Commission to lower its expectations of the Company merely because AI has failed to meet minimum service quality standards – especially given the Commission's desire to establish a plan that incents the Company to improve service quality in this critical area.

Accordingly, GCI/City urge the Commission to retain the 95.44% benchmark for this service quality measure.

2. Out of Service Over 24 Hours

In this section of the HEPO, the Examiners dodge the question of whether the Company should be instructed to alter the way it calculates its OOS>24 Hours measure. GCI/City witness TerKeurst presented uncontroverted testimony that the Company overstates the "Act of God" or weather-related exceptions to meeting this benchmark (thereby improving their performance numbers) by removing "Act of God" outages from the numerator (which represents the number of outages that exceeded 24 hours) and then dividing that number by a figure that represents the total of all outages, *including "Act of God" outages*.

The Commission should adopt Ms. TerKeurst's recommendation to require the Company, when calculating its performance on this measure, to exclude outages associated with "Acts of God" from the denominator, just as they have been from the numerator. To permit the Company to continue calculating this measure in this flawed manner gives AI the green light to distort its performance in this critical service quality area.

3. Repeat Trouble Rate – Installation and Repair

While the HEPO correctly recognizes the need to measure repeat trouble rates for installation and repair categories, the Examiners adopt a single measure for these two critical service quality performance areas, separate the benchmarks and divide the assigned penalty equally between them.

GCI/City urge the Commission to separate these two critical performance measures and assign a benchmark of 5% for installation repeats and 10% for repair repeats, based on the Company's own internal targets. Adopting the Company's proposed benchmarks of 16.90% for installation repeats and 13.92% for repair repeats, while also dividing the penalty between these two service quality areas, effectively locks in the Company's poor performance in these areas. It also minimizes AI's incentive to improve its

service quality in this area.

For these reasons, GCI/City urge the Examiners to adopt Ms. TerKeurst's recommendation to separate these important measures and implement benchmarks of 5% for installation repeats and 10% for repair repeats.

4. Missed Installation Commitments

Although the Examiners recognize the need for measuring AI's failure to meet its installation commitments, they inappropriately fail to distinguish between AI-promised installation appointments (requiring field visits) and installation commitments (promises to install by a date certain). In addition, the Examiners again lock in a deficient level of service quality by adopting a benchmark of 90% for regular service commitments met because of a lack of data that excludes vertical services.

GCI/City urge the Examiners to separate the Missed Installation Appointment and Missed Installation Commitment categories, and reject the benchmark adopted by the Examiners in favor of a 1% benchmark for each of these measures, based on AI's own internal measures. As noted earlier in the GCI/City Reply Brief, during cross-examination, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, Company witness Hudzik admitted that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

Accordingly, GCI urges the Commission to adopt Ms. TerKeurst's proposed POTS % Missed Installation Commitments Due to Company Reasons measure and POTS % Missed Installation Appointment measures and incorporate a 1% benchmark for each.

5. Average Speed of Answer – Repair

Having correctly recognized Average Speed of Answer – Repair as a critical customer service category by adding it as a measure in the plan, the Examiners, unfortunately, adopt a lax standard that relies on data derived during the price cap plan. Accordingly, this benchmark is unsuitable for determining whether the plan will maintain service quality.

GCI/City urge the Commission to adopt Ms. TerKeurst's proposed "80% Answered Within 20 Seconds" benchmark, which is consistent with the Company's own internal performance target. The notion that the Company's own internal targets are too strict to use as benchmarks is unpersuasive, given that AI

witness Hudzik testified that IBT has met its own internal benchmarks and, in fact, modifies them to a stricter level to inspire improved performance.

At a minimum, a 45.8 second benchmark should be established, which represents the Company's best annual average performance during the life of the plan. Adoption of this benchmark would then ensure that service quality is "at a minimum, maintained", consistent with the statutory directive.

6. Average Speed of Answer – Customer Calling Centers

Again, GCI/City endorse the Examiners' recognition that a critical service quality area from a customer's standpoint is the average time it takes AI to respond at its calling centers, having adopted it as a new standard for the new plan. However, the Examiners again make the mistake of locking in what is essentially deficient service quality expectations by using the minimum Part 730 requirement of 60 seconds average answer time as the benchmark. In addition, the Examiners' approach fails to separate business and residential call center performance.

GCI/City urge the Commission to separate the call center performance measure so that residential call center and business call center answer times are monitored separately. The record evidence supports such a distinction. First, IBT processes residential and business customer calls in separate centers. Second, because IBT currently monitors and measures its average speed of answer performance for each type of customers separately, a requirement that the Company report its performance separately for each type of customer group will add no burden to IBT. Third, separating the measures will ensure that the Company does not discriminate in its response time to residential customers when compared to business customers. GCI/City Ex. 12.0 at 37. The Company acknowledged during cross-examination that, from a mathematical standpoint, not disaggregating this measure could result in one customer class receiving significantly different service quality performance from the Company than the other class. Tr. 1839.

Moreover, as detailed by Ms. TerKeurst, the Company's performance has been quite erratic to varying degrees in both the residential and business call centers. GCI Ex. 2.0 at 40. It is essential to separate the business and residential call center answering times in order to ensure that the Company does not mask service quality differences between customer classes. GCI's proposed separation of the measures also guards against discriminatory behavior favoring business customers. GCI Ex. 12.1 demonstrates that calls to business call centers are currently answered much more promptly than calls to residential centers.

Ms. TerKeurst testified that IBT's established target for residential customers call centers is 60 seconds. However, the Company's internal target for business call centers is 80% of calls answered within 20 seconds. This 80% of calls answered within 20 seconds also be adopted for residential customer call centers. Staff also proposed that this benchmark be employed, albeit for a combined residential/business customer call measure.

An assessment of whether IBT's service quality is being maintained should compare its current performance with its performance during years prior to alternative regulation. For service quality measures for which IBT has not provided pre-plan data, such as these measures, the Company should generally be held to meeting either its own internal standard or the performance it achieved during the "best" alternative regulation year for which data is available.

Given the erratic, differing answer times between the residential and business customer call centers as described above, and the Company's own internal target, the Commission should adopt GCI's proposed benchmark of 80% within 20 seconds and maintain separate measures for the residential and business customer call centers.

7. Percent of Calls Answered

Confused by the record, the Examiners in this portion of the HEPO direct the parties to "better explain the measure, benchmark and their respective positions in their Exceptions.

To clarify, GCI/City recommends the inclusion of abandoned call measures for the residential, business and repair customer call centers, in accordance with Ms. TerKeurst's recommendations. As discussed by Ms. TerKeurst, these measures would be very useful in identifying any trend in the percent of calls that are abandoned because of excessive delays in response time. Staff witness Cindy Jackson pointed out in testimony that IBT data suggests that an increase in the average speed of answer results in an increase in the percent of calls abandoned by customers. Moreover, as detailed by Ms. TerKeurst, Company data shows that the percent of calls answered was markedly better for business than residential customer call centers. GCI/City Ex. 2.0 at 45. This phenomenon supports the establishment of separate Percent of Call Answered measures for the residential and business call centers. Measuring such data is equally important for repair call offices.

In short, the Percent of Call Answered measure provides another indicator of IBT's accessibility and

responsiveness to customer inquiries and service needs. Although the Company has a 90% target level as its own internal measure, a 95% level should be established as the benchmark for each of these three measures. As noted by Ms. TerKeurst, IBT has been exceeding the 90% target benchmark. GCI/City Ex. 2.0 at 46. Thus, its use as a standard could result in a degradation of service. Instead, the benchmark should be based on IBT's actual performance to safeguard against erosion of service quality as required by Section 13-506.1(b)(6) of the Act. Moreover, use of such a standard would be consistent with the Commission's rationale for establishing a standard for the Company's % Installation Within 5 Days measure that was above the standard in Part 730 of the Commission's rules. See Alt. Reg. Order at 58.

Accordingly, the Commission should adopt three separate Percent of Call Answered standards, with a benchmark of 95 percent, for residential, business and repair call centers.

8. Mean Installation and Repair Intervals

The HEPO fails to adopt, let alone address, the GCI/City proposals to create new benchmarks measuring the Company's Mean Installation Interval and Mean Repair Interval. Creation of these benchmarks is critical to diminish any incentive the Company might have to stop attempting to meet the repair and installation benchmarks because of a recognition that performance has been inadequate to satisfy the annual benchmarks.

Staff witness Sam McClerren testified that the degree by which the Company misses a service quality benchmark is of concern to the Commission. Tr. 1798. If the Company misses the Installation Within 5 Days benchmark at any given time, the situation can become markedly worse depending on the amount of time beyond the five-day interval customers are forced to wait. Currently IBT maintains a POTS Mean Installation Interval that measures the average business days taken to install POTS service only. GCI/City Ex. 2.0 at 47. It also tracks installations for both POTS and other services combined. Id. at 46-47. Financial consequences for failure to meet a POTS Mean Installation Interval benchmark would provide an invaluable safeguard against prolonged delays for installations that take more than 5 days. Such a measure would discourage the Company from moving customers whose POTS has not been installed within 5 days to the bottom of the work queue before service is ultimately installed. GCI Ex. 12.0 at 40. The measure would encourage IBT to install all POTS lines as soon as possible regardless of whether the Installation-Within-5-Days measure had been met.

In its Brief, IBT argues that "it has never engaged in the practice that Ms. TerKeurst alleges", and hence suggests that no factual basis exists for adopting the POTS Mean Installation Interval measure. IBT Brief at 82.

This argument should be rejected. First, the Company cites no testimony from any Company witness who asserted this has never happened. Second, the record evidence shows and it is common knowledge that many IBT customers were forced to wait weeks last summer for the installation of a POTS line. AI Ex. 12.0 at 9. Accordingly, including a financial incentive that would discourage supervisors from letting customer requests for POTS lines languish in a work queue when it is determined that the Installation Within 5 Days benchmark has not been reached is critical to the maintenance of service quality.

Ms. TerKeurst recommended that a benchmark for this measure be set at four business days. If IBT is supposed to complete 95.44% of installations within five days, it is reasonable that the standard for mean installation intervals would be less than five business days. GCI/City Ex. 2.0 at 48. It is important to remember that the word “mean” is defined as the mid-point between two extremes. This definition highlights the conservative nature of the 4-day benchmark. GCI urges the Commission to adopt this proposed standard and benchmark.

The Commission should also adopt the GCI/City-proposed POTS Mean Time To Repair measure. Like the POTS Mean Installation Interval, including the GCI-proposed POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan would provide the Company with a financial incentive to ensure that service outages that exceed 24 hours are not neglected even longer. GCI/Ex. 12.0 at 41. Currently, IBT measures its POTS Mean Time to Repair, with an internal benchmark of 21 hours. GCI Ex. 2.0 at 49. Ms. TerKeurst testified that there is reason for the Commission to monitor this performance area. The Company’s mean time to repair POTS lines has significantly increased from an average of 24.32 hours in 1999 to an average of 40.25 hours in 2000 (through September), with the mean time to repair POTS lines hitting 77.72 hours in September, 2000. Id. at 49-50. Given the Company’s poor performance in the POTS Mean Time to Repair area, establishing a target level of 21 hours would encourage improvement and should be adopted.

Again, the Company argues in its Brief that no evidence exists that the Company engaged in behavior wherein outages that were not repaired within 24 hours were put on the backburner. Again, this argument misses the mark. A check of the citations offered as support for this statement in the Company’s Brief reveals that no witness ever made such an assessment. The fact is that a financial incentive currently exists, whether it has been acted upon or not, for technician crews to pass over requests for repair if it can be determined that the outage has surpassed the 24-hour mark.

The record evidence shows that the Company’s performance in the area of repairing service outages needs

to be monitored closely given its abysmal record at satisfying the OOS>24 benchmark. GCI urges the Commission to provide the Company with a financial incentive to restore service as quickly as possible to all customers by including a POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan approved in this docket.

C. Phase-In of New Benchmarks

The HEPO adopts AI's proposal to phase-in new service quality benchmarks over three years. For each new benchmark adopted in the Order, the benchmark for the first year is to be set two percent from the benchmark adopted, the benchmark for the second year will be set one percent from the benchmark adopted and the benchmark in the third and subsequent years will be set at the benchmark adopted. HEPO at Section VII, Subsection E.

The Examiners explain this generous concession with the statement that "a three-year phase-in will better coincide with both the Company's planning and budgeting cycle and with the Commission's annual review of the Plan. Id. Any phase-in of the service quality standards adopted in this Order should be rejected for a couple of reasons.

First, the Commission did not believe such a phase-in was necessary when it first established the eight benchmarks that are a part of the existing service quality penalty mechanism. The notion that it could be financially affected by poor service quality performance was just as new to AI in 1994 as it is in 2001. Nevertheless, the Commission ordered no phase-in of benchmarks.

Second, all of the benchmarks adopted in the HEPO and proposed by GCI/City are service quality measures that the Company already tracks. Accordingly, there is no need to accommodate some alleged need to "prepare" its planning and budgeting cycles for the additional measures.

Accordingly, GCI/City urge the Commission to reject any kind of phase-in of the newly adopted service quality benchmarks.

D. Incentive Structure

In their Conclusion regarding the appropriate incentive or penalty structure to be adopted on a going-forward basis, the Examiners write that "we regard the Company's specific performance of its service quality obligations as our preeminent goal." HEPO at Section VII, Subsection F. GCI/City take exception with this declaration, proposing instead that the Commission's preeminent goal in reviewing the current Price Cap Plan is to satisfy the statutory directives that require, among other provisions that, at a minimum, service quality be

maintained and rates be fair, just and reasonable. The Commission should not lose sight of the fact that both the General Assembly and customers' value fair, just and reasonable rates as much as the maintenance of service quality.

That being said, GCI/City supports the Examiners conclusions that:

- (1) remove the service quality penalty provision from the price cap formula;
- (2) strengthen existing penalties to incite the investment the Company needs to make in both manpower and equipment to maintain basic service quality; and
- (3) provide the credits to those customers directly affected by service quality failures.

GCI/City, however, are particularly troubled by certain statements in the HEPO that allow the Company to deduct individual customer credits and "reasonable administrative costs" associated with implementing the penalty and customer compensation schemes from the penalty amounts the Company might otherwise owe for failure to meet any of the adopted benchmarks. HEPO at Section VII, F. In addition, GCI/City except to the Examiners' assumption that the \$30 million penalty for violations of the OOS>24 standard supplanted, rather than was added to, the existing penalty in the price cap formula. Other corrections or exceptions to proposed language in this Section of the HEPO follow.

**1. Customer Credits And "Reasonable Administrative Costs" Should Not Be Deducted
From AI's Annual Service Quality Penalty Amount.**

The Examiners' conclusion that AI's customer credits and "reasonable administrative costs" should be deducted from any annual service quality penalty amounts paid at the end of each year should be rejected for several reasons.

First, permitting the Company to deduct from its overall penalty amount all customer credits paid during the year essentially removes any incentives it might have to keep customer credits (and therefore poor service quality performance) to a minimum. If the Company knows, for example, that it will recoup any and all individual customer credit penalties from the overall penalty amount, it is only reasonable to assume that poor performance in these areas takes on a lesser importance from a financial perspective each year.

This assumption is valid when one considers that U.S. tax laws hope to encourage charitable contributions by providing income deductions for individual and corporate taxpayers. While it perhaps cannot be said that AI will be *incited* to miss the repair and installation benchmarks, it is fair to say that the incentive to meet these benchmarks dissipates if the Company knows that it ultimately will be reimbursed, assuming annual service quality benchmarks are missed.

For this reason, the Commission should strike the language in the HEPO that permits the Company to deduct the individual customer credits from any penalty owed at the end of each year.

The Examiners' caveat that "reasonable administrative costs" should be deducted from the annual service quality penalties paid is another invitation to AI to engage in bad behavior. First, as is becoming increasingly clear in the AI Merger Savings Docket (01-0128), the litigation of annual reports of expenses is a complicated process. Given the Examiners' interest in simplifying the penalty component of the plan, it makes no sense from a policy or legal perspective to permit the Company to introduce in each annual filing docket its own, unaudited assessment of what its penalty structure administrative costs were for the year. It is a given that Staff and Intervenor would want to analyze the figures provided by AI and cross-examine the numbers to the extent deemed necessary. The existing annual filing proceeding, however, is not set up to accommodate such litigation. Indeed, the Commission in its last annual filing order acknowledged this fact when it ordered the establishment of separate proceedings for the litigation of merger savings and cost estimates.

Second, permitting the Company to recoup its "reasonable administrative costs" is such a vague instruction as to invite abuse. No specificity is provided as to what would constitute "reasonable" costs. GCI/City urge the Commission not to attempt to define such costs in its final Order, but merely reject the notion of reimbursement altogether.

Moreover, it is a given that the Company incurs "administrative costs" each time it is required after the Commission's annual filing order to reduce rates in accordance with the price cap formula. The Commission did not see fit to award such compensation in 1994 when it established the existing service quality penalty mechanism, and it should likewise not do so now.

3. OOS>24 Penalty

The Examiners also erred when they wrongly assumed that the \$30 million penalty approved by the Commission in the Merger Order for AI's failure to meet the OOS>24 Hours standard supplanted the original

penalty structure in the price cap formula. In fact, the Commission stated in that Order:

In subsequent full calendar year periods (including calendar year 2000), the Joint Applicants shall demonstrate compliance in the same manner currently used by the Commission and Ameritech Illinois to measure the Company's compliance with the OOS>24 service standard or face a one-time, \$30 million assessment, *separate and apart from any annual rate reduction resulting from the service quality component of the company's Alternative Regulatory Plan.*

Merger Order at 24 (emphasis added). This highlighted language makes clear that the Commission intended that the \$30 million penalty was a condition of approval of the Merger, and was to be assessed in addition to any service quality penalty included under alternative regulation.

GCI/City urge the Commission, therefore, to ensure that violations of the OOS>24 standard are punished with both the penalty mechanism approved in this Order *and* the \$30 million penalty the Commission ordered as a condition in the Merger docket.

3. Customer-Specific Penalties / Cell Phones

The Proposed Order does not provide for any customer-specific penalties coincident with the Company's failure to keep installation and repair appointments. Likewise, the HEPO concludes that the provision of cell phones to customers who personally experience installation and service-outage-repair delays at the hand of the Company would be administratively unwieldy.

To incent the Company to honor its appointments with customers and to schedule appointments realistically, GCI/City urge the Commission to include a penalty provision that would result in a \$50.00 payment or credit to the consumer, unless the Company notifies the consumer 24 hours in advance. In addition to creating appropriate customer service incentives, this measure provides reasonable compensation to consumers who have lost time from work or otherwise managed their schedule to await a repair or installation appointment. In addition, this penalty level is consistent with the level recently approved by the General Assembly in the new telecommunications bill now awaiting the Governor's signature.

In addition to providing the above direct consumer compensation, GCI/City proposes that IBT be ordered to establish a cellular telephone loaner program, so people who are without service can have telephone service available to them while they await installation or repair. GCI Ex. 2.0 at 87. Because so many CLECs are resellers, they are still dependent on IBT for basic service connections and some repairs. It is therefore crucial that this program be available to wholesale as well as retail customers, so IBT does not use it to obtain a competitive

advantage over CLECs. GCI Ex. 2.0 at 88.

These additional direct customer compensation measures are necessary to insure that the people inconvenienced by service quality degradation are compensated for the time they spend without telephone service, for the time and money they lose waiting for technicians who never appear, for the money they lose by having to obtain replacement service, for the money lost from missing work days or business calls, and for the increased risk associated with being unreachable when medical and other emergencies arise.

4. Wholesale Service Quality

The Examiners fails to address wholesale customer service quality, concluding that such issues can be raised and addressed in other proceedings. HEPO at Section VII, Subsection G. 3. The Commission should reject the temptation to ignore this important issue.

First, to the extent that alternative regulation is designed to foster a transition to a more competitive environment, the Commission must recognize that the issue of whether potential competitors, who must purchase network elements and other services from the incumbent carrier, receive adequate service from the monopoly carriers is relevant.

As GCI/City noted in its Briefs, consumers of wholesale services, such as CLECs who provide local service through resale or UNEs, should also be entitled to compensation. Otherwise IBT consumers would receive compensation for poor quality service, but CLECs and their customers would not receive equal treatment. GCI Ex. 2.0 at 84. This could have the unintended consequence of further degrading services to CLECs, and undermining the growth of competition, because IBT may give higher priority to consumers for whom it is obligated to pay compensation than to CLEC customers.

Accordingly, GCI/City urge the Commission to strike the conclusion on this issue offered by the Examiners and apply all penalty mechanisms to wholesale customers as well.

5. Miscellaneous Penalty Exceptions

GCI/City strongly except to the final statement made by the Examiners in this portion of the HEPO, which reads: “In closing out this section of our Order, we remind AI that nothing is expected of the Company only that it work to maintain service quality at the required levels.” HEPO at Section VII, Subsection F. The notion that “nothing is expected of the Company” except to maintain service quality at the required levels flatly contradicts the statutory directive that any alternative regulatory plan approved by the Commission shall satisfy the criteria listed in

Section 13-506.1(b). Indeed, when it comes to creating an alternative regulatory plan, the General Assembly made it clear that much is expected of the Commission in terms of satisfying the statutory goals articulated throughout the Act, as specifically set forth in Section 13-506.1(a) through (f). The Examiners' conclusion in this regard, therefore, should be stricken from the Commission's final Order.

With respect to the Installation Within 5 Days customer credit portion of the HEPO, the Examiners state that one-half of the non-recurring installation charges should be credited to customers who have their order completed within *seven* to nine business days. No reason is provided for waiting until the seventh day to provide a customer credit, rather than the sixth day. GCI/City assume this is an unintentional mistake in need of correction. Moreover, adjusting this portion of the Order to read "*six* to nine days" is consistent with the proposed new Telecommunications legislation now awaiting the Governor's signature.

VIII. OTHER ISSUES

The HEPO failed to mention the extensive record concerning the earnings and operations of AI for 1999, the year AI selected as its test year. AI, Staff and GCI/City submitted extensive testimony addressing AI's cost of capital, its depreciation, its rate base, and its expenses. Staff and GCI/City presented the Commission with recommendations concerning rate design, to accommodate the rate decreases that their analyses supported. Excluding such a major portion of the record from a proposed order deprives the Commission of analysis and a full understanding of the issues presented. GCI/City submit Exceptions and the following argument about these issues.

Although the HEPO recommends that rates should not be changed, the Hearing Examiners determination that there was no need to discuss revenues and expenses, including depreciation, is beyond reasonable justification. As the Staff of the Commission properly recognized in its testimony, despite the Staff's recommendation that rates may not need to be reduced, the Commission may disagree with that recommendation and find that current rates are not just and reasonable. Accordingly, a thorough discussion of the accounting issues and an analysis of its return were warranted.

A. EARNINGS ANALYSIS

Both the Public Utilities Act and the Commission's findings in the Price Cap Order make clear that reinitializing rates at just and reasonable levels at the start of the plan is essential to satisfying the statutory

requirement of 13-506.1(b)(2) that the plan produce “fair, just and reasonable rates”. Failure to reinitialize rates at the start of any new plan ensures that the going-in rates will *not* be just and reasonable.

Given the changes in the AI alternative regulatory plan adopted in this Order, it would be both counter-intuitive and contrary to Section 13-506.1(b) to establish a new plan whose going-forward rates have not been adjusted to correct for the inadequacies of the existing regulatory plan. The Commission recognized this fact back in 1994, when it found that in order to satisfy the statutory requirement that rates be “fair, just and reasonable”, it would begin the plan with rate changes “in order to establish just and reasonable rates *and to establish an appropriate starting point for the alternative regulation plan.*” Price Cap Order at 186. The Commission further stated: “*After rates are initialized, the price index mechanism will continue to produce reasonable rates.*” Id.

To be clear, upon recognizing that rate reinitialization must occur in order to establish an alternative regulatory plan that satisfies the statutory requirement that rates be fair, just and reasonable, the Commission is obliged to examine the proposed operating income and rate base adjustments and determine which are supported by a preponderance of the evidence. As such, the rate reduction level ultimately approved by the Commission will be a product of the rate of return/return on equity level ultimately selected by the Commission as appropriate for AI’s going-in rates and the operating income and rate base adjustments approved as reasonable.

For purposes of examining the Company’s revenue requirement, the test year in this docket comprises the twelve months of actual data from the period beginning January 1, 1999 and ending December 1, 1999. Both Staff accounting witnesses and GCI witness Ralph C. Smith examined the Company’s 1999 jurisdictional rate base and operating income statement and concluded that the Company is significantly overearning. After reviewing all of the data provided by the Company in testimony, exhibits, and responses to scores of data requests propounded by both GCI and the Commission Staff, Mr. Smith concluded that the Company is earnings a 43.08 percent return on equity for intrastate operations and a 28.49 percent return on intrastate rate base. GCI/City Ex. 6.2 at 3. His review of the Company’s intrastate revenue requirement shows an Illinois intrastate revenue excess of \$956 million, as shown on GCI Ex. 6.3, Schedule A Revised, reflecting an 11.80% return on equity ,and demonstrating the need to reinitialize rates prior to the establishment of any kind of going-forward regulatory plan.

Staff’s own accountants likewise determined that the Company is significantly overearning, finding that the Company’s earned return on equity amounted to 40.09% (Staff Ex. 30.0, Schedule 30.01). Staff accountants concluded that should the Commission reinitialize rates, a significant rate reduction is in order, having computed a

revenue excess of \$824 million for the 1999 test year, reflecting a 10.52% overall rate of return. Staff Ex. 30.0 at 4 and App. A to Staff's Initial Brief.

As noted in CUB's Initial Brief (p.108), even the Company's own calculation of its adjusted net operating income and adjusted intrastate rate base for the 1999 test year, which *do not* incorporate any of the operating income and rate base adjustments recommended by either Mr. Smith or the Staff witnesses and *does* incorporate its own pro forma adjustments that effectively lower its reported earnings, reveals an intrastate revenue excess of \$276 million. GCI Ex. 6.5, Schedule A Revised. Clearly, a significant rate reduction for the Company's going-forward rates is in order.

Having rejected rate reinitialization in their cursory analysis of the justness and reasonableness of rates under the new plan, the Examiners omitted any discussion in the Proposed Order of any of the operating income and rate base adjustments proposed by the Commission Staff and GCI/City. The arguments for the GCI/City proposed adjustments, and the response to the Company's opposition to these adjustments are contained in CUB's Initial Brief and in the GCI/City Reply Brief, already filed with the Commission. The attached Exceptions incorporate all of the arguments presented by the parties and provide specific language for Commission adoption of these necessary adjustments. GCI/City urge the Commission to rewrite the Examiners' Proposed Order and (1) make a finding that rate reinitialization is required for the rates in the going-forward plan to be just and reasonable, and (2) adopt the specific GCI/City-proposed adjustments discussed in these Exceptions.

B. Depreciation

Presumably, the Hearing Examiners concluded that a discussion of Ameritech's revenue and expenses for the 1999 test year was unnecessary because of its rejection of the need to reinitialize or adjust AI's rates. This decision, of course, fails to provide the Commission with a full analysis of all of the record evidence, including substantial evidence concerning depreciation, Ameritech's largest single expense, should the Commission choose to disagree with the Hearing Examiners' recommendations.

The HEPO does mention the 200 pages of testimony, with supporting exhibits, admitted into the record through GCI/City's depreciation expert, William Dunkel. GCI/City Ex. 8, 9, * Mr. Dunkel is a nationally recognized depreciation expert and has testified on numerous occasions on behalf of state regulatory commissions. Similarly, the HEPO fails to discuss the testimony on depreciation presented by Staff or Ameritech.

As the Hearing Examiners know, this case presents the first opportunity for the Commission to

review a telecommunications carrier's performance under an alternative regulation plan. Accordingly, the issue of whether the plan produced just and reasonable rates, as framed by the requirements of Section 13.506.1, is one of first impression that deserves a full and thorough review of all of the issues and evidence. Certainly, the 1994 Order provides a basis for the Commission to review Ameritech's depreciation policy if it deemed it warranted.

GCI/City categorically reject Ameritech's assertion that the 1994 Order stripped the Commission of the authority to examine the appropriate level of depreciation expenses on a going forward basis. Although the 1994 Order granted the company flexibility in setting depreciation levels during the Plan, the Commission is empowered to make these adjustments in determining AI's earnings level. In the 1994 Order, the Commission expressly advised Ameritech that it would continue to monitor Ameritech's depreciation policies and practices and if any abuses were found, the Commission would re-evaluate the propriety of the Alternative Regulation Plan. Alt Reg Order at 55.

The HEPO's failure to deal with this issue, if left uncorrected, would force the Commission to rely on the depreciation expense advocated by the company --one that is not based on sound accounting principles -- because no other analysis was provided. Had the HEPO fairly addressed the depreciation issue, the Commission would find Ameritech's depreciation expense too high and the return it reports too low.

Ameritech originally reported a depreciation expense of \$768 million for 1999 test year purposes. By the time the record was marked heard and taken, all parties, including Ameritech, agreed that this expense level is unsupportable and too high. When the calculations used to arrive at that figure were reviewed by GCI/City witness Dunkel, it became clear that Ameritech was continuing to depreciate accounts that had already been fully depreciated. Ameritech, on cross examination, was forced to admit a \$160 million error. Yet, despite this clear indication that Ameritech's figures should be subject to strict scrutiny by the Commission, the HEPO gave the depreciation expense absolutely no scrutiny.

As set forth in the testimony submitted by GCI/City, and argued in initial and reply briefs, Ameritech's depreciation expense calculations contain several additional errors which when corrected, result in a proper depreciation level of \$382.4 million. Those arguments are discussed in the proposed language submitted with is brief and will not be repeated here.

C. Cost of Capital

The revenue requirement calculation performed by GCI/City witness Smith incorporates an 11.80% cost of equity figure. This number represents the low end of the common equity recommendation made by Staff in this proceeding. Staff Ex. 11.0 at 29.

Like the other revenue requirement inputs, the cost of capital and cost of equity evidence is not discussed by the Examiners in the HEPO, presumably because they rejected any rate reinitialization proposal. GCI/City urges the Commission to adopt the low end of Staff's proposed return on equity recommendation. Selection of the lower, 11.80% figure is appropriate for several reasons.

First, in its 1994 Alt Reg Order, the Commission determined the low end of Staff's proposed return on equity range was appropriate in recognition of the benefits the Company stood to gain under alternative regulation. Alt Reg Order at 174. In doing so, the Commission determined:

In order to ensure a benefit to ratepayers from alternative regulation as required by the Act, the Commission adopts a return on equity of 11.36% based on the low end of Staff's CAPM and DCF calculations. Choosing the low end of the return on equity range is reasonable given the change in circumstances under alternative regulation. The Company will no longer face the constraints that it did under traditional rate of return regulation. For example, the Company will be allowed to set its own depreciation schedules (except for LRSIC studies, aggregate revenue tests and imputation studies) and will be allowed some price flexibility. Furthermore, the Company will benefit from the significant potential increase in earnings that it can obtain under alternative regulation. Hence, using the low end of a reasonable range of return on equity is appropriate.

Id. Of course, all of the advantages gained by AI in 1994 as a result of the adoption of price cap regulation remain today. Should the Commission adopt another alternative regulation plan, the Company will enjoy the same benefits that accompany the establishment of price cap regulation, namely the ability to set its own depreciation rates, increase its pricing flexibility and, most importantly, retain earnings in excess of its allowed rate of return.

Second, as discussed by GCI/City witness Smith in GCI/City Ex. 6.2 (Smith Rebuttal), the 11.8% ROE figure is reasonable in comparison to the cost rate for common equity for intrastate telephone operations in other recent cases in which Mr. Smith participated as a witness, as shown in the above table.

The 11.80% return on equity proposed by GCI/City is also consistent with the cost of equity analysis produced by AI witness Dr. Roger Ibbotson. Dr. Ibbotson found that the range of investor required return is 12.86 - 12.71%. AI Ex. 6.0. The low end of Staff's and AI's cost of equity range are within 6 basis points of each other, and the Commission can rely on that consensus to conclude that a reasonable cost of equity for AI is 12.80%. Staff's high end cost of equity calculation and its midpoint calculation (14.40 and 13.10 respectively) are both higher than AI's high end number of 12.71% and clearly are not appropriate or accurate figures.

Accordingly, GCI/City urges the Commission to adopt an 11.8% cost of equity, which represents Staff's

low end of its recommended return
on equity range for purposes of
computing AI's revenue
requirement for the reinitialization
of AI's rates.

X. In Implementing rate reinitialization, the Commission should reduce the residential NAL by \$1.30 per month per line and adopt GCI/City's Rate Design.

GCI/City submit that the HEPO should discuss and evaluate the rate design proposals submitted by the various parties in order to inform the Commission about the record evidence and proposals to implement a rate

reduction. In this regard, GCI/City are the only parties that submitted a comprehensive rate design proposal advocating reductions for virtually all services including the NAL. Staff has provided testimony indicating its preferences that usage and vertical services rates should be reduced. Ameritech takes the position that the network access line rate and Band A rates should not be reduced in the event rate reductions are ordered. GCI/ City have provided language discussing the rate design issue and supporting essentially across the board reductions.

The HEPO also fails to include any discussion or analysis regarding a rate moratorium for basic residential services. GCI and City submit that the record shows that an extension of the rate moratorium for basic residential services, as that termed is defined in the 1994 Order, is warranted. Back in 1994, the Commission was concerned that residential consumers needed protection from the exercise of monopoly power. Nothing has changed. No party, not even Ameritech, disputes the fact that entry into the residential market has been practically nonexistent. To prove the point to the Commission that the residential captive customer remains at risk, one need look no farther than Ameritech's petition to "rebalance rates" that would have increased residential NAL rates by \$84 million. This request was properly denied in the HEPO.

Rejecting Ameritech's petition to rebalance rates alone, however, is insufficient to protect residential customers. Residential consumers are still at risk. Ameritech will continue to seek ways to increase rates for basic residential services in the absence of competition and in the absence of a rate moratorium. Accordingly, the rate moratorium for basic residential services must be extended. Language has been provided in the accompanying Exceptions.

X. HB2900, Which Did Not Change Section 13-506.1 and Has Not Yet Been Signed into Law, Should Not Be Applied to this Proceeding.

GCI/City recognize that the General Assembly has passed House Bill 2900, which rewrites portions of Article XIII. The Bill has not been signed by the Governor and is not effective yet. GCI/City have not addressed the impact of this Bill on this docket, although GCI/City note that section 13-506.1, which controls the standards for alternative regulation, has not been changed.

GCI/City reserve the right to address the effect of HB 2900 in the appropriate proceeding.

CONCLUSION

GCI/City request that the Commission adopt the attached Exceptions for all the reasons stated therein and in this Brief on Exceptions.

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company)	
)	
Application for Review of Alternative Regulation Plan)	Docket No. 98-0252
)	
Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates)	Docket No. 98-0335
)	
Citizens Utility Board and People of the State of Illinois, ex rel. James E. Ryan, Attorney General of the State of Illinois, Complainants)	
)	
vs.)	Docket No. 00-0764
)	
Illinois Bell Telephone Company d/b/a Ameritech Illinois, Respondent)	(consolidated)
)	

GCI/CITY BRIEF ON EXCEPTIONS

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